



This is a digital copy of a book that was preserved for generations on library shelves before it was carefully scanned by Google as part of a project to make the world's books discoverable online.

It has survived long enough for the copyright to expire and the book to enter the public domain. A public domain book is one that was never subject to copyright or whose legal copyright term has expired. Whether a book is in the public domain may vary country to country. Public domain books are our gateways to the past, representing a wealth of history, culture and knowledge that's often difficult to discover.

Marks, notations and other marginalia present in the original volume will appear in this file - a reminder of this book's long journey from the publisher to a library and finally to you.

### Usage guidelines

Google is proud to partner with libraries to digitize public domain materials and make them widely accessible. Public domain books belong to the public and we are merely their custodians. Nevertheless, this work is expensive, so in order to keep providing this resource, we have taken steps to prevent abuse by commercial parties, including placing technical restrictions on automated querying.

We also ask that you:

- + *Make non-commercial use of the files* We designed Google Book Search for use by individuals, and we request that you use these files for personal, non-commercial purposes.
- + *Refrain from automated querying* Do not send automated queries of any sort to Google's system: If you are conducting research on machine translation, optical character recognition or other areas where access to a large amount of text is helpful, please contact us. We encourage the use of public domain materials for these purposes and may be able to help.
- + *Maintain attribution* The Google "watermark" you see on each file is essential for informing people about this project and helping them find additional materials through Google Book Search. Please do not remove it.
- + *Keep it legal* Whatever your use, remember that you are responsible for ensuring that what you are doing is legal. Do not assume that just because we believe a book is in the public domain for users in the United States, that the work is also in the public domain for users in other countries. Whether a book is still in copyright varies from country to country, and we can't offer guidance on whether any specific use of any specific book is allowed. Please do not assume that a book's appearance in Google Book Search means it can be used in any manner anywhere in the world. Copyright infringement liability can be quite severe.

### About Google Book Search

Google's mission is to organize the world's information and to make it universally accessible and useful. Google Book Search helps readers discover the world's books while helping authors and publishers reach new audiences. You can search through the full text of this book on the web at <http://books.google.com/>





B 22/1:106-34

FED-DOCS

**H.R. 21—THE HOMEOWNERS' INSURANCE  
AVAILABILITY ACT OF 1999**

---

**HEARING**

BEFORE THE

**COMMITTEE ON BANKING AND  
FINANCIAL SERVICES**

**U.S. HOUSE OF REPRESENTATIVES**

**ONE HUNDRED SIXTH CONGRESS**

**FIRST SESSION**

\_\_\_\_\_  
**JULY 30, 1999**  
\_\_\_\_\_

Printed for the use of the Committee on Banking and Financial Services

**Serial No. 106-34**



DEPOSITO

MAR 24 2000

STANFORD UNIVER  
JONSSON LIBRARY

Digitized by Google





# H.R. 21—THE HOMEOWNERS' INSURANCE AVAILABILITY ACT OF 1959

---

## HEARING BEFORE THE COMMITTEE ON BANKING AND FINANCIAL SERVICES U.S. HOUSE OF REPRESENTATIVES ONE HUNDRED SIXTH CONGRESS FIRST SESSION

JULY 30, 1959

Printed for the use of the Committee on Banking and Financial Services

Serial No. 106-34



56-655 OC

U.S. GOVERNMENT PRINTING OFFICE

WASHINGTON 25, D.C.

For sale by the U.S. Government Printing Office  
Department of Commerce, Congressional Sales Administration  
5000 S. 2nd Street, Wash., D.C. 20540

## HOUSE COMMITTEE ON BANKING AND FINANCIAL SERVICES

JAMES A. LEACH, Iowa, *Chairman*.  
BILL McCOLLUM, Florida, *Vice Chairman*

MARGE ROUKEMA, New Jersey  
DOUG K. BEREUTER, Nebraska  
RICHARD H. BAKER, Louisiana  
RICK LAZIO, New York  
SPENCER BACHUS III, Alabama  
MICHAEL N. CASTLE, Delaware  
PETER T. KING, New York  
TOM CAMPBELL, California  
EDWARD R. ROYCE, California  
FRANK D. LUCAS, Oklahoma  
JACK METCALF, Washington  
ROBERT W. NEY, Ohio  
BOB BARR, Georgia  
SUE W. KELLY, New York  
RON PAUL, Texas  
DAVE WELDON, Florida  
JIM RYUN, Kansas  
MERRILL COOK, Utah  
BOB RILEY, Alabama  
RICK HILL, Montana  
STEVEN C. LATOURETTE, Ohio  
DONALD A. MANZULLO, Illinois  
WALTER B. JONES JR., North Carolina  
PAUL RYAN, Wisconsin  
DOUG OSE, California  
JOHN E. SWEENEY, New York  
JUDY BIGGERT, Illinois  
LEE TERRY, Nebraska  
MARK GREEN, Wisconsin  
PATRICK J. TOOMEY, Pennsylvania

JOHN J. LaFALCE, New York  
BRUCE F. VENTO, Minnesota  
BARNEY FRANK, Massachusetts  
PAUL E. KANJORSKI, Pennsylvania  
MAXINE WATERS, California  
CAROLYN B. MALONEY, New York  
LUIS V. GUTIERREZ, Illinois  
NYDIA M. VELAZQUEZ, New York  
MELVIN L. WATT, North Carolina  
GARY L. ACKERMAN, New York  
KEN BENTSEN, Texas  
JAMES H. MALONEY, Connecticut  
DARLENE HOOLEY, Oregon  
JULIA M. CARSON, Indiana  
ROBERT A. WEYGAND, Rhode Island  
BRAD SHERMAN, California  
MAX SANDLIN, Texas  
GREGORY W. MEEKS, New York  
BARBARA LEE, California  
VIRGIL H. GOODE JR., Virginia  
FRANK R. MASCARA, Pennsylvania  
JAY INSLEE, Washington  
JANICE D. SCHAKOWSKY, Illinois  
DENNIS MOORE, Kansas  
CHARLES A. GONZALEZ, Texas  
STEPHANIE TUBBS JONES, Ohio  
MICHAEL E. CAPUANO, Massachusetts

BERNARD SANDERS, Vermont

# CONTENTS

	Page
Hearing held on:	
June 30, 1999 .....	1
Appendix:	
June 30, 1999 .....	73

## WITNESSES

FRIDAY, JUNE 30, 1999

Beery, Donald E., Vice President, Eustis Insurance, Inc., on behalf of the Independent Insurance Agents of America .....	38
Connery, Barbara, Director, North Carolina Association of Realtors, on behalf of the National Association of Realtors .....	58
Eizenstat, Hon. Stuart E., Deputy Secretary, Department of the Treasury .....	11
Gilliam, Scott A., Assistant Secretary and Director of Government Relations, The Cincinnati Insurance Companies .....	60
Hanna, Ronald E., Deputy Insurance Commissioner, State of Mississippi .....	34
Hansen, Darryl D., Chairman, President and CEO, GuideOne Insurance Group, on behalf of the National Association of Independent Insurers .....	55
Joslin, Roger, Chairman of the Board, State Farm Fire and Casualty Company .....	32
Miller, Thomas, Director of Economic Policy Studies, Competitive Enterprise Institute .....	57
Myers, Mary Fran, Co-Director, Natural Hazards Research and Applications Information Center, University of Colorado .....	40
Nutter, Franklin W., President, Reinsurance Association of America .....	36
Pike, Robert W., Executive Vice President, Secretary and General Counsel, Allstate Insurance Company .....	53
Plunkett, Travis, Legislative Director, on behalf of J. Robert Hunter, Director of Insurance, Consumer Federation of America .....	42
Weber, Jack F., President, Home Insurance Federation of America .....	43

## APPENDIX

Prepared statements:	
Leach, Hon. James A. ....	74
Bachus, Hon. Spencer .....	82
Cook, Hon. Merrill .....	84
Kelly, Hon. Sue W. ....	88
Lazio, Hon. Rick .....	170
Royce, Hon. Edward R. ....	177
Ryan, Hon. Paul .....	229
Beery, Donald E. ....	277
Connery, Barbara .....	381
Eizenstat, Hon. Stuart E. (with chart) .....	231
Gilliam, Scott A. ....	386
Hanna, Ronald E. ....	247
Hansen, Darryl D. ....	356
Hunter, J. Robert (with attachments) .....	297
Joslin, Roger .....	242
Miller, Thomas .....	362
Myers, Mary Fran .....	283
Nutter, Franklin W. (with attachments) .....	252
Pike, Robert W. ....	349
Weber, Jack F. ....	310

(III)

	Page
<b>ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD</b>	
Leach, Hon. James A.:	
Testimony of Florida State Representative Stan Bainter, August 25, 1997 .....	75
Letter to Hon. Rick Lazio from Rep. Bainter, July 12, 1999 .....	79
Cook, Hon. Merrill:	
National Association of Home Builders, policy statement .....	86
Kelly, Hon. Sue W.:	
Temporary Panel on Homeowners' Insurance Coverage Report to Gov. Pataki, February 1999 .....	90
Lee, Hon. Barbara:	
Written questions for Hon. Stuart E. Eizenstat .....	175
Royce, Hon. Edward R.:	
"Can Insurance Pay for the 'Big One'?", by J. David Cunningham, Neil Doherty and Anita Lo, Wharton School, University of Pennsylvania .....	184
Renaissance Reinsurance letter to Hon. James A. Leach, June 11, 1999 ...	182
U.S. RE Corporation letter to Frank Nutter, July 28, 1999 .....	179
Myers, Mary Fran:	
"Disasters by Design: A Reassessment of Natural Hazards in the United States" .....	285
Weber, Jack F.:	
"The Case for a Federal Disaster Reinsurance Program" June 1999 .....	316
Response to the Reinsurance Association of America's Testimony and "Fact" Sheet .....	346
The Chubb Corporation, policy statement .....	393
The Western League of Savings Institutions, policy statement .....	397

## **H.R. 21—THE HOMEOWNERS' INSURANCE AVAILABILITY ACT OF 1999**

**FRIDAY, JULY 30, 1999**

**U.S. HOUSE OF REPRESENTATIVES,  
COMMITTEE ON BANKING AND FINANCIAL SERVICES,  
Washington, DC.**

The committee met, pursuant to call, at 9:50 a.m., in room 2128, Rayburn House Office Building, Hon. James A. Leach, [chairman of the committee], presiding.

Present: Chairman Leach; Representatives McCollum, Roukema, Bereuter, Baker, Lazio, Bachus, Royce, Kelly, Weldon, Cook, Hill, Ryan, LaFalce, Vento, Kanjorski, and Sherman.

Chairman LEACH. The hearing will come to order. On behalf of the committee, let me extend a warm welcome to Deputy Secretary Eizenstat and our distinguished panel of private witnesses.

The committee meets today to receive testimony on H.R. 21, the Homeowners' Insurance Availability Act of 1999, introduced by the Housing Subcommittee Chairman Rick Lazio and the Committee Vice Chairman Bill McCollum and sponsored by twenty Members of the committee.

We will be recessing today starting at 11:00 for an hour so Members can attend the memorial service for our former colleague, George Brown, in the Capitol. Because we have limited time, it is my hope we can keep opening remarks brief.

H.R. 21 addresses the threat of natural disasters to the availability of adequate and affordable homeowners' insurance. It is similar to legislation passed by the committee in the 105th Congress with bipartisan support.

The committee will hear today from a broad spectrum of witnesses who have been asked to address philosophical, as well as practical, questions regarding the nature and role of the Federal Government on this issue. The committee has worked with the Administration in every step of the legislation's development, and I am especially looking forward to the comments from Deputy Secretary Eizenstat.

It is my hope that legislation can be advanced which will represent real opportunity for families to protect their homes, while at the same time avoiding significant contingent liabilities by the Federal Government. In this regard, it is my intention to remain open-minded in the pursuit of a consensus which satisfies these priorities. Based on our hearing today, I hope to be in a position to consider bringing legislation to the floor early this fall.

At this point, I would now like to ask John if he has any opening comments.

[The prepared statement of Hon. James A. Leach can be found on page 74 in the appendix.]

Mr. LaFALCE. Thank you very much, Mr. Chairman.

First, I would like to welcome the new Deputy Secretary of the Treasury, Stu Eizenstat. This is his first appearance before our committee with that title. He has had a few titles in the past, and he has appeared before us under those auspices.

Mr. Eizenstat truly is one of the finest public servants that I have had the pleasure of working with from the day I first met him, and I believe that was sometime in 1976. Certainly, beginning January of 1997, we began having almost a day-to-day working relationship on a whole wide range of issues.

I think you started out, Stu, as what, the Domestic Policy Advisor to the President? And I can't begin, you know, to remember all the positions. I don't have your bio in front of me. Whether it was Ambassador, where you were coming in from the State Department to Commerce Department. In any event, I know now that you are the Deputy Secretary of the Treasury Department and you have a portfolio, though as I understand it, that includes not only those responsibilities of the Treasury Department, but you carry over some other responsibilities because of the fine work you did in those areas.

You have always proceeded in an objective, a bipartisan manner, and our committee is delighted at your new position. I think I can speak for all of us in saying we look forward to working with you very, very closely.

Now, on the subject of the day, I am very pleased we are having today's hearing to address the issue of improving the availability of natural disaster insurance for homeowners in high-risk insurance markets. How our society responds to losses caused by catastrophic events is an extremely important and, compared to most issues, an extremely complex issue. Continuing changes in weather patterns and new developments in our reinsurance and capital markets clearly add to this complexity. I think it is important to define, before we do anything else, the nature and extent of the problem that is being addressed in this legislation.

Contrary to some allegations, we do not confront a situation where basic homeowners' insurance is unavailable in portions of the country. Nor have we seen any breakdown or incapacity in the market for catastrophe reinsurance. I think the April subcommittee hearing was very helpful in clarifying both of those points.

We do confront a problem of pricing as opposed to capacity. In areas considered high risk for catastrophic events, the cost of both primary and reinsurance coverage for damage due to hurricanes and earthquakes is extremely high. Many primary insurers have simply chosen not to offer this coverage, or not to purchase reinsurance to help reduce the cost of such coverage for consumers, and this leaves many homeowners in the difficult position of going without specialized catastrophe coverage; and it puts greater pressure on Government at all levels to help pay the cost of major disasters that are not covered by private insurance.

The question that Congress must address is whether there is significant public need for affordable disaster insurance coverage in

high-risk markets and whether this need is great enough to warrant Federal involvement.

If we agree that a Federal effort is needed, a second consideration is whether the reinsurance program proposed in H.R. 21 presents the best approach for addressing this problem.

Given the increased incidence of major disaster events in the past decade, as well as escalating property and construction costs in high-risk areas, it is difficult for any single locality or State or any grouping of insurance companies to adequately cover all potential costs of a major catastrophic event. These events tend to strike regions rather than States.

The Federal Government, however, does have the capacity to adequately spread the cost of such events broadly enough to make catastrophe coverage available on a broad basis. The private marketplace has developed its capacity significantly and may, in time, develop adequate capacity, but there is a need to address the reality that catastrophic disasters can occur at any time, even today.

H.R. 21, which I have co-authored, provides a vehicle to address these issues, and many of my initial concerns about this legislation were addressed in amendments adopted by the committee last year, and all of those changes have been incorporated in this year's legislation.

We have come a long way in crafting a workable approach in H.R. 21, but our work may not be finished. Treasury has some very strong concerns with the way that Federal liability is limited and reinsurance payments are allocated under the bill. These are legitimate concerns and we must address them.

Business and consumer groups have made compelling arguments for the need to assure that greater resources of the insurance industry are committed before any Federal reinsurance payments are made. Those concerns require careful consideration.

I also believe that more attention must be given to encouraging effective loss mitigation activities in order to ensure that Federal involvement actually helps reduce the potential costs of major disasters rather than merely spreading the costs more broadly. FEMA has some strong views in this area, and we should have the opportunity to hear from them.

This past week, I asked that several additional witnesses be invited, and they were. Unfortunately, a number were unable to attend today's hearing on such short notice. The New York Superintendent of Insurance has released a detailed report assessing the current market for catastrophe reinsurance, and he has recommended against the creation of any State catastrophe fund.

The capital markets also have introduced a number of promising alternatives for spreading catastrophe risks that should be included in either today's or a future discussion. Our committee will, if we are to proceed as we should, hear from these perspectives also.

These are issues that I encourage all of today's witnesses to address, along with any additional recommendations or proposals that might help our committee improve this bill.

I join the Chairman in welcoming Deputy Secretary Eizenstat and all of today's witnesses. I thank the Chair for his kind indulgence.

Chairman LEACH. Thank you, John.



Mr. Lazio.

Mr. LAZIO. Thank you, Mr. Chairman. Let me thank you for putting together what promises to be an exceptionally balanced hearing, airing the views of all sides; that again reflects your philosophy.

And welcome, of course, to the Deputy Secretary, and I compliment him not only on his work with respect to natural disaster insurance, homeowners' insurance, but on a whole range of other issues and, most particularly, the Holocaust Asset Commission on which he has been a driving force.

This committee and this Congress have been focused on the issue of liquidity among homeowners' insurance markets for almost ten years, and over the last three years we have been acutely focused on the legislation before us today. Last year, we reported out legislation identical to our proposal with strong support from both sides of the aisle.

In the simplest terms, our efforts today are about providing maximum opportunities for families across America to protect their homes. Many of us here take the ability to insure our homes for granted, but it is not so easy for working families in Missouri or North Carolina or Texas and many other States, not to mention California or Florida. For them, the forecasts of more frequent and more forceful storms over the next few decades only bring uncertainty and fear of the future.

Today, Mr. Chairman, we are likely to hear about the zero sum game among businesses and industries, the reinsurance industry and the insurers, who gains and who loses, but in the end I think we need to focus on the people, the public, the families, the exposure that they face and the possible loss of their most important asset, their homes.

It is about people like 87-year-old Mildred O'Shaughnessy whose home of 51 years was destroyed just last year when Hurricane Georges hit Louisiana. Mrs. O'Shaughnessy has been unable to find insurance to protect her home, so now she is forced to rely on her family and donations from the community for shelter and the necessities of life.

Some States have been able to rebuild in the aftermath of natural disasters from the early 1990's, but for the most part, that ability has been simply a matter of luck. For example, devastated by \$16 billion in insured losses from Hurricane Andrew in 1992, the property insurance market in Florida virtually collapsed. Since then, Florida has been somewhat successful in encouraging the re-expansion of the private market, and today they can absorb about \$11 billion in insured residential losses, but that success has only been possible for one reason, Mother Nature has spared Florida a major disaster during that time. It also pales in comparison to what a major hit in southern Florida might mean to that market.

Other committees have already acted in this Congress to address issues associated with the rising costs of natural disasters. In March, the House passed two separate bills designed to address the issue of disaster mitigation, and our colleague, Mr. Terry and others on this committee were co-sponsors of one of those pieces of legislation.

So clearly, the House has recognized the importance of mitigation efforts in preparing for natural disasters. And as is appropriate, it is an issue being dealt with by the committee of relative jurisdiction.

Our proposal creates an environment where the private market is encouraged to re-engage in the business of homeowners' insurance across the country. In subcommittee hearings this Congress, we have heard testimony that a more stable and confident private insurance market in vulnerable areas of the country would benefit all Americans.

Since 1983, taxpayers have spent more than \$80 billion in Federal assistance effort disaster relief. It is true that population growth and coastal development play a part in rising costs of natural disasters, but it is also true that within the next ten years, according to the U.S. Census Bureau, almost 75 percent of our total population will live within 100 miles of a U.S. coastline. Regardless of anything we do here today, we cannot mandate where people and families live and we cannot forcefully relocate families living in cities like Miami, New Orleans, Seattle, Los Angeles, St. Louis, Memphis or New York.

Today we may hear that there is no longer a lack of available and affordable homeowners' insurance. The facts dispute that. We may also hear that there is an overabundance of reinsurance capacity. That also is contested by the facts.

Tell that to Mrs. O'Shaughnessy. Tell that to the hundreds of thousands of families who are forced into insurance pools of last resort across the country, which in some areas have grown by more than 800 percent over the last six years. They simply would not be necessary if we had adequate reinsurance.

Mr. Chairman, we could wait to take action until Congress is forced to act in the wake of some future earthquake or hurricane in the middle of a panic, or we could proceed deliberately and calmly without the environmental crisis that would accompany a major catastrophe.

Mr. Chairman, one way is a responsible approach to public policymaking. The other is not.

I want to thank you again for your even hand and for your balanced approach to this hearing.

[The prepared statement of Hon. Rick Lazio can be found on page 170 in the appendix.]

Chairman LEACH. Thank you.

The Chair would like to stress we have an awkward long day based upon having a delayed markup, or a hearing from last Wednesday, because of the Brown funeral. I would like to ask Members to keep opening comments, if they can, as brief as possible.

Mr. Vento.

Mr. VENTO. I will be brief, Mr. Chairman.

I am pleased we are having this hearing. I supported this bill in the last session, but I am happy to have another look at it. I think that many of us are very uneasy with this step into an assumption of a responsibility by the national Government. As meteorological science improves and the insurance entities are better able to protect risks, they understand the inevitable problems with some sec-

tors of the country in terms of homeowner losses and have withdrawn from the markets in these areas, and obviously there are questions about reinsurance availability and the affordable cost of this.

I hope indeed that the mitigation efforts are not stopped. Certainly we are very reluctant to demand mitigation efforts, and trying to do zoning from the national level has been generally unacceptable to most jurisdictions.

I think it is important that Under Secretary Eizenstat, whom I welcome, along with my friend John LaFalce and many others on the committee, see someone who has been in Washington almost as long as I have. It is good to see you here, Stuart.

Mr. EIZENSTAT. Thank you.

Mr. VENTO. But I think his testimony points out the necessity of not supplanting, but supplementing what is going on, to provide the necessary framework so that we can, in fact, establish a private sector initiative and to permit that to go forward in terms of doing the job that it has historically done.

Obviously, our work with disaster assistance and other matters is not going to go away on the basis of this endeavor, but it is good to try and provide, or to develop a private market, but hopefully to try and not outguess what the market will do. So I think we have to be very careful as we go down this road, and I commend the Members working on it and the witnesses that we have today.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you, Mr. Vento.

Mr. McCollum.

Mr. MCCOLLUM. Thank you very much, Mr. Chairman. I certainly appreciate your holding the hearing today.

As we all know, this is the second time that this legislation has been before the committee in the last Congress. The bill that Rick Lazio and I introduced this year was, indeed, what was passed by this committee and ultimately presented to the floor, though too late for consideration.

The reason for it is, I think, very obvious, because we have in earthquake-prone States, and in States like mine in Florida, hurricane-prone States, tremendous problems with insurance availability and potentially with greater costs even than now for homeowners, because of the risks that are involved with the absence of a private marketplace with respect to reinsurance for insurance companies. And while there may be other factors involved, when you have the 1-in-100-year event, the really big hurricane, the really big earthquake, there frankly is no protection for insurers in terms of their potential losses if they issue this kind of insurance.

Consequently, if we don't do something, I don't think it is simply a question of even availability in some of the States for insurance in the future or higher premiums. It is going to be a question of a huge loss to the American taxpayers, because just like with Hurricane Mitch in Honduras and Guatemala and Nicaragua this last year, there will be a call for aid the likes of which we haven't seen here before for a disaster in our own country, and that will undoubtedly be done. We will wind up approving it.

So I believe that while there may be some perfections that need to be done to this legislation, that today's hearing can give us some

guidelines as to what those are; but ultimately we need to produce this legislation, and we need it badly, before we get to the point where the terribly difficult 1-in-100-year event does occur, and a Hurricane Andrew strikes downtown Miami instead of striking south of it, and then we all have a tremendous problem on our hands beyond what we can foresee right now.

But I thank the Chairman for holding the hearing, look forward to working with him on crafting whatever product we ultimately produce, and I thank you very much for the time.

Chairman LEACH. Well, thank you, Mr. McCollum.

Does anyone else seek recognition?

Mr. COOK. Mr. Chairman.

Chairman LEACH. Excuse me one minute. I think Mr. Sherman on this side, please.

Mr. SHERMAN. Thank you.

Chairman LEACH. Mr. Sherman.

Mr. SHERMAN. Mr. Chairman, thank you for holding these hearings. Since I represent Northridge, I regard this as a matter of earthshaking significance.

The current system has not completely broken down, but at least in southern California the cost of earthquake insurance is horrendous and then it comes with an enormous deductible that makes it almost worthless. And we are just one earthquake away from a breakdown in the insurance system, because if there was another earthquake in southern California in the aftermath and in the several years after that, you may not be able to get earthquake insurance; you may not be able to sell your home or even refinance it.

The reinsurance markets have developed to some extent, but at least my State, I believe, is paying 10 times the actuarial value for the reinsurance it is buying on the private market. We do have a Federal interest in risk mitigation and one in encouraging people to purchase insurance, and by making disaster insurance affordable and providing reasonable coverage, we can meet that Federal interest.

Thank you, Mr. Chairman.

Chairman LEACH. Well, thank you very much. For a unanimous consent request, I recognize the gentleman.

Mr. BAKER. I just ask unanimous consent to submit my statement for the record.

Chairman LEACH. Without objection.

Mr. Bachus.

Mr. BACHUS. Thank you. I would ask unanimous consent. I have got a rather lengthy statement which I won't make.

I have one area of concern, and I hope to work with Mr. Lazio and others who are sponsoring the bill, and that is the balance between the private and the public sector. We don't want to crowd out the private sector. There are a lot of studies recently that show that reinsurance is plentiful, that it is cheap, that its availability is rising. And it may be that the trigger level in this legislation needs to be revised, and I will submit my concerns in a statement. Thank you.

[The prepared statement of Hon. Spencer Bachus can be found on page 82 in the appendix.]

Mr. ROYCE. A brief statement, Mr. Chairman.

Chairman LEACH. One second.

Any other statements on the Democratic side?

Please, Mr. Royce.

Mr. ROYCE. Thank you, Mr. Chairman.

Mr. Chairman, this legislation is premised on the view that the supply of reinsurance in the private marketplace is not adequate to meet the demands of a catastrophic natural disaster, and before we decide to turn over to the Federal Government the role of providing reinsurance, I think we should consider that recent studies indicate that the capacity of the private marketplace to handle these losses is far greater than is contemplated by H.R. 21, which sets trigger levels at \$2 billion.

For example, the 1995 study by U.S. Re Corporation, which has been cited by this committee as an authoritative analysis of the total supply of reinsurance, has now been updated by a much more recent July 1999 study. That revised analysis suggests that for much of the country capacity has more than doubled from \$7 billion to \$14 billion per region since four or five years ago when that report was first produced. A similar conclusion was reached in a study by Renaissance Reinsurance.

Take California, for example: The increased capacity is pegged at \$11 billion. In addition, both reports suggest that additional capacity is available from other forms of reinsurance agreements and from the capital markets which have brought significant new capital to the table by securitizing natural disaster risk.

Taken together, there is closer to \$20 billion of reinsurance available per region, significantly greater capacity than the outdated figures upon which this legislation is based.

These numbers are significant because they illustrate the fact that the private marketplace for reinsurance has grown significantly in recent years and is much better prepared to handle catastrophic natural disasters. Indeed, as a third study conducted by the Wharton School and published just two weeks ago concluded that gaps in catastrophic risk financing are presently not sufficient to justify Federal Government intervention in private insurance markets in the form of catastrophic reinsurance, and that was just two weeks ago that that study came out.

A massive new Federal disaster program, in my view, Mr. Chairman, would only hinder further innovation and growth in the private sector, potentially pushing out private reinsurance companies and leaving the taxpayer with much greater liability.

I appreciate you allowing me to give my thoughts, Mr. Chairman.

[The prepared statement of Hon. Edward R. Royce can be found on page 177 in the appendix.]

Chairman LEACH. Thank you, Mr. Royce.

Mrs. Kelly.

Mrs. KELLY. Thank you, Mr. Chairman. I ask unanimous consent to insert my statement in the record.

Chairman LEACH. Without objection.

[The prepared statement of Hon. Sue W. Kelly can be found on page 88 in the appendix.]

Mrs. KELLY. As a part of my statement, Mr. Chairman, I would like to also insert in the record the February 1, 1999, study, "A Report to Governor Pataki and Members of the New York State Legis-

lature by the Temporary Panel on Homeowners' Insurance Coverage."

Chairman LEACH. Without objection.

Mrs. KELLY. Thank you.

[The information referred to can be found on page 90 in the appendix.]

Chairman LEACH. Mr. Cook.

Mr. COOK. Yes, thank you, Mr. Chairman. I would like to ask unanimous consent to insert my statement into the record.

[The prepared statement of Hon. Merrill Cook can be found on page 84 in the appendix.]

I would just like to point out that the cost of natural disasters is approaching \$1 billion a week in America, and I would like to reemphasize the strong support that H.R. 21 currently enjoys with over 97 co-sponsors and, additionally, several real estate groups like the National Association of Realtors, the National Association of Home Builders, whose members face this and other types of homeowners' insurance issues every day, support this bill strongly. In fact, I would like to ask unanimous consent that a statement in support of H.R. 21 on behalf of the National Association of Home Builders be submitted for the record.

Chairman LEACH. Without objection.

[The information referred to can be found on page 86 in the appendix.]

Mr. RYAN. Mr. Chairman.

Chairman LEACH. Yes.

Mr. RYAN. I would also ask unanimous consent to insert my statement in the record.

Chairman LEACH. Without objection.

Mr. RYAN. I would also like to lend my 2 cents worth with some of my colleagues, which is, we do have new data. We do have a new study which shows that there is approximately \$20 billion of reinsurance sold per region.

And I also have the same sorts of concerns that we may be overreaching here, we may be undermining the private insurance markets, we may be crowding out better alternatives; and it is something that we really have to police and watch very, very closely, that we do not overreach in this area.

It may be a point of moving triggers, but there is a threshold to which we can crowd out these private market incentives, private new tools that are on the horizon, and I hope that this committee does not pass legislation which does so.

[The prepared statement of Hon. Paul Ryan can be found on page 229 in the appendix.]

Chairman LEACH. Thank you, Mr. Ryan.

Mr. Hill.

Mr. HILL. Thank you. Mr. Chairman, I want to thank you for holding this hearing and echo the comments of others in allowing us to fully flesh out the issues here.

I have many concerns about the bill, but the most significant has to do with the triggers, and there are three triggers in the bill. One, they are described as the greater of either \$2 billion, the capacity of the State cap mechanism, or a 1-in-100-year event.

These three criteria are—discussing them is much like discussing apples and oranges. \$2 billion is an arbitrary set dollar amount. The significance of that trigger would change dramatically when the nature and geographic boundary of that event changed.

Example, a \$2 billion trigger in California is significantly different than a \$2 billion trigger in Montana. Likewise, the loss being capacity of a State mechanism bears no relationship to anything except perhaps the willpower of the State taxpayers. Certainly a \$10 billion capacity in California would be substantially different than a \$10 billion trigger in Montana or Texas for that matter.

The most confusing, I think, clearly the most misunderstood, is the 1-in-100-year event trigger. In 1982, Ten Mile Creek flooded the Helena Valley, my home. It was caused by 10 inches of rainfall falling on the Continental Divide 10 miles away, hence the name Ten Mile Creek. It was a 1-in-500-year event and it caused a couple of million dollars' worth of damage.

Now, in the Helena Valley along Ten Mile Creek, this was a massive, catastrophic event, but on a national scale it would probably hardly cause a blip.

A 1-in-100-year event that is based on a national or global scale event, that might occur in California, is of significantly different magnitude than a 1-in-100-year event that would occur in the same place when the scale is more narrow—say, the State of California.

Expressed another way, 1-in-100-year earthquake event in California would be a lesser magnitude earthquake than a 1-in-100-year event based on a U.S. scale and even lesser than a magnitude event on a world scale.

Further, this criteria bears no relationship whatsoever to the economic impact. For that reason, we need to completely re-examine the matter of the triggers.

We should be trying to protect simply the solvency of the insurance industry, not events, the purpose of which is to make insurance more available to consumers at a lower cost. Events of certain economic impact, not intensity, are what impose the economic risk. The trigger should be set at a level higher than the capacity industry, both the primary insurance and reinsurance industry, and it should be calculated by first establishing the capacity of primary insurance and then the reinsurance in capital market alternatives.

My calculations would put these triggers at somewhere between \$25 billion and \$40 billion.

Now, what we need to do here is to calculate what the appropriate capacities of individual insurers are for a probable maximum loss, so that whatever reinsurance contracts we have are really adjusted or suited to the needs of individual insurers, based upon their exposure.

It is my hope that we will be able to understand these issues better from this hearing and perhaps approve this bill so that it can pass.

Thank you, Mr. Chairman.

Chairman LEACH. Thank you very much. Does anyone else seek recognition?

If not, we would like to begin with the Deputy Secretary, and I would like to just take 15 more seconds to echo everything Mr. LaFalce indicated.

We are pleased you are in your position, Stuart, and we look forward to your testimony.

**STATEMENT OF HON. STUART E. EIZENSTAT, DEPUTY  
SECRETARY, DEPARTMENT OF THE TREASURY**

Mr. EIZENSTAT. Thank you, Mr. Chairman, and Representative LaFalce, Members of the committee. I appreciate the opportunity to discuss this important issue, and I want to begin by complimenting you, Mr. Chairman, Mr. LaFalce, Representatives Lazio, McCollum, and Barney Frank, for whom we pray a speedy recovery from the operation he will be having, and other Members of the committee for their bipartisan leadership in facilitating the deliberations on this important legislation.

Your collective and individual skills, insight and perseverance, we believe, will lead to a good legislative outcome.

The Administration's view with respect to this important issue can be summarized as follows: The characteristics of natural disasters make the financial risks associated with them especially difficult for both private insurers and reinsurers to handle. In the wake of a major disaster, prices tend to spike, leading to a contraction in the availability of homeowners' insurance and to a reduction in reinsurance.

Given the states of development of the private markets for this risk today, we are persuaded that there is a limited interim role for the Government to play with respect to the reinsurance of the most severe, most remotely probable of these events.

The principles that we believe should be respected as we move forward are that the Government's role in this area must be designed so as to leave more than enough room for private market activity to flourish, and so the taxpayers are thoroughly and adequately compensated for all risks borne by the Government. We view the legislation before us as a constructive step forward in addressing these problems, but as Secretary Summers and the Department have noted, there remain concerns about some important aspects of the bill.

Turning to our specific concerns with the legislation, we believe first that this committee should seriously consider whether the cap on annual pay-outs will adequately serve the objective you have in mind. I will be outlining in some detail an alternative approach that we have been exploring and that we believe may offer a more robust tool for fiscal control.

The Administration, under the leadership of James Lee Witt, the Director of FEMA, has developed a comprehensive policy dealing with natural disasters, going beyond simply the response to them; but trying to help in working with local communities, making them less prone to natural disasters. We see the legislation before this committee as a potential complement to this policy.

We also believe that the appropriations requirement currently in the legislation should be removed in order to bring this program into conformance with general practice of other Federal insurance



programs and to promote maximum clarity that the Government will make good on its financial obligations.

Finally, with respect to the issue of triggers, which I will get into in more detail in a moment, we believe that the triggers should be set neither so high as to make the program irrelevant to State programs and private entities, nor so low as to crowd out private market activity.

There are no easy answers to how this should be accomplished. On the whole, however, our instinct is toward the cautious end of the spectrum. So in balancing these competing considerations, we would put greater emphasis on avoiding crowding out.

Three considerations argue for prudent interim participation of the Federal Government in this market. First, the Federal Government is uniquely capable of spreading risk across the population and over time.

Second, the Federal Government would likely bear part of the costs associated with stabilizing collapsing insurance markets in a truly cataclysmic event regardless whether legislation of this type existed.

And finally, the prudent participation at this stage of development may enhance the ability of private markets to deal with these risks.

We are guided by a common set of common-sense principles that Secretary Summers has laid out. Federal involvement must be supported and not supplant private insurance markets. It should apply only to true catastrophes that the private market is not capable of handling and it should be strictly transitional, phasing out as private markets develop.

The Federal Government must share and not subsidize risk, and it must be at no net cost to the taxpayer.

The legislation now before the committee is a generally positive step forward in this regard and creatively responds to the difficulty faced by both State funds and private entities in purchasing reinsurance against their large but low-probability risks. The bill has improved as it has moved through the legislative process, and we hope it will continue to do so, because we continue to have some concerns which are as follows:

First, with respect to the cap, the proposed legislation would cap annual pay-outs at \$25 billion. If claims in any one year exceeded that amount, each claimant would receive a prorated portion of the \$25 billion.

We obviously share your objective of developing a fiscally prudent piece of legislation. However, after careful study, we believe that the cap on annual insurance pay-outs may not be the best way to limit Federal liability.

It would be difficult for the Federal Government to withhold pay-out on claims under this program on the argument that such a pay-out might later need to be prorated against claims from another event, and then if a second event were to occur within the same insurance year, it is entirely plausible that future Congresses and administrations would make full payment on all claims stemming from the second event, notwithstanding the requirement to prorate.

The only alternatives would be either to recall monies paid out pursuant to the first event or to impose the full burden of the annual cap on the victims of the second event. Neither is realistic.

We would like to suggest a possible approach on the cap issue, which is demonstrated by this chart, copies of which we have handed out to all Members.

It would involve limiting the amount of insurance to be sold rather than the amount of the pay-out to be made. Contracts sold under the legislation would cover 50 percent of any losses above the threshold level that triggers the Federal pay-out, up to an upper limit corresponding to the dollar amount that would be lost in the event of a more remote possibility.

With your permission, if each of you would perhaps look at this chart, which is based on the concept of reinsurance offered, if in the State of Florida there were a 1-in-100-year loss, this is estimated to be \$13 billion. For 1-in-500-year loss, the estimate is \$26 billion in the State of Florida.

Under our suggestion, the Federal liability would be capped at half the difference between \$26 billion, the top 1-in-500-year event; and \$13 billion, the 1-in-100-year event; or \$6.5 billion.

This loss would occur only if the industry actually purchased all the contracts that were offered.

The aggregate maximum Federal pay-out then would be computed as the sum of the maximum obligations in each State and region. Our preliminary data—and please understand this is more back-of-the-envelope, ballpark estimates—indicates that if the upper limit were set at the dollar amount associated with a 1-in-500-year event, in each State and region, the maximum Federal liability in any given year would be on the order of \$50 billion.

Under this approach, that maximum liability is easily dialed up or down by adjusting the probability associated with the upper limit.

Under this approach, the Government would sell only a limited amount of insurance, but having sold it, it would make good on all of it. It also has the advantage, Mr. Chairman and Members of the committee—and you can see this by the white part of the bar next to the \$6.5 billion—of leaving room for the private sector as well as the amount that the Federal Government would take, which is shown by the blackened area.

Of course, the deductible amount would also be covered by the private sector.

A second concern has to do with appropriated pay-outs. The proposed legislation would require that all pay-outs from the fund and borrowings by the fund be subject to congressional appropriations. In our opinion, this casts a potential shadow over the certainty of full pay-out and could therefore limit the number of bidders and possibly dampen their aggressiveness in bidding. The net result could be that the Federal Government would receive a less favorable price for its reinsurance. This concern could be addressed by striking out the requirements for appropriations of pay-outs and borrowings.

The threshold trigger levels for a Federal pay-out, as I indicated, are an extremely important parameter of the proposed legislation. They have to be designed to strike an important balance between

two very important considerations. On the one hand, the triggers should not be set so high that the program becomes irrelevant for either State programs or private participants; on the other, Federal involvement shouldn't crowd out private sector activity. This program should insure only losses of true catastrophes that the private market is incapable of handling.

In conclusion, Mr. Chairman, our suggestions derive from two core concerns: that relief for insured homeowners not come at the expense of taxpayers and that any Federal program share risk and support the private markets.

The current proposed legislation provides a sound foundation for progress in this area, and we look forward to working with Members of this committee to resolve remaining issues.

Thank you very much.

[The prepared statement of Hon. Stuart E. Eizenstat can be found on page 231 in the appendix.]

Chairman LEACH. Well, thank you, Mr. Secretary.

Let me just begin with the most basic query, and that is, obviously from a taxpayer's perspective any program in this area presents a potential contingent liability on the Government, which means the taxpayers.

It is also obvious that lack of a program presents alternative Government expenditures.

And so one of the great questions is: Is it prudent to go forth with a new approach under the assumption that: A, one wants to, under reasonable projections, have it pay for itself; but B, if there are unreasonable situations that develop, will the costs be less than the alternatives?

And I assume, based upon your testimony, which is presenting a little bit different alternative, that you accept the premise that the alternative approach is very expensive to the taxpayer and that moving people into an insurance setting is probably cheaper for the Government in the long run than otherwise. Is that a valid assumption?

Mr. EIZENSTAT. Yes, sir. I think our feeling is that there are costs to the Federal Government associated with natural disasters in any event. That is one of the reasons that, under Mr. Witt's leadership, we are trying to develop proactive and preventive measures. We also believe that under the pricing that has been provided here, there should be no net cost to the taxpayer.

Now, in something as uncertain as this, one can never be absolutely sure, but we think that it is likely that there would be no net cost and that, as you properly point out, there are costs to doing nothing.

Chairman LEACH. Then the final premise that I would like you to address is that one of the extraordinary aspects of this country is that we have an insurance industry and then we have a reinsurance industry, both of which are quite vital. But it does appear that there is a circumstance of enormous national catastrophes that even the insurance and the reinsurance industries have a difficult time contemplating as both a reasonable business risk or cost-effective risk, and therefore, there is a role for Government to step in. Is that a valid assumption?

**Mr. EIZENSTAT.** Yes, sir. We think that there is a market gap here. One of the reasons that we stress and that the legislation stresses, the interim nature of this with, for example, a ten-year sunset clause, is because we hope that that gap will, over time, be filled by the capital markets. There is already a securitization market which is developing, and the reinsurance market is growing. But there is a gap, and that gap, we believe, ought to be filled in the interim.

**Chairman LEACH.** I thank you.

Let me just conclude by saying I appreciate the introduction of your chart as symbolic of an approach that you think the committee ought to seriously consider. I have a very open mind to that, and we will, in the wake of this hearing, look at this approach very seriously.

**Mr. EIZENSTAT.** Thank you. It is really designed, Mr. Chairman, to try to make sure that there is a genuine cap, and our concern is simply that having the \$25 billion cap with the notion that you would prorate additional disasters doesn't take into account the political realities that when that second disaster occurs, the pressures will be enormous to pay the full amount out. We think this provides a more certain cap at a somewhat higher level of assumption.

**Chairman LEACH.** Thank you, Mr. Secretary.

**Mr. LaFalce.**

**Mr. LAFALCE.** Thank you very much, Mr. Chairman.

I share your open-mindedness on this question and look forward to dialoguing with not only the Administration, but everyone to better grapple with these issues.

I am not sure that I fully appreciate the Administration's perspective, however. One of your concerns with the \$25 billion cap is it may not effectively be a cap because it would not preclude future Congresses from acting to provide full repayment.

Is there any less likelihood that the alternative you have suggested to us would preclude a future Congress from politically deciding to provide fuller payment than is required under that alternative proposal?

I don't quite see it.

**Mr. EIZENSTAT.** Yes, sir. First, I want to thank you, again, for your very kind words.

The difference is that the proposal in the bill is based on a payout concept. Ours is based on a sale concept, so that you can only offer for sale at the beginning of each year a certain amount of insurance, and that would establish immediately a ceiling and then the Government would pick half of that up. So it would be very difficult for a Congress to change that without literally amending the legislation in ways which we think would be much more difficult to do.

**Mr. LAFALCE.** I really don't see that. You know, this is a political question rather than a technical, legal question, and if there is a political desire to exceed a cap of \$25 billion, I don't know why there would be any less of a political desire to exceed a cap based upon premiums that have been purchased.

You know, I mean, I can just see it right now. If there is a problem in Florida, they are going to say, "The heck with it, we have got to get reimbursed."

Mr. EIZENSTAT. But there wouldn't be—insurance simply wouldn't have been out there. You won't have the insurance out there for that political pressure to apply against because you have only issued a certain amount of insurance since our base is, again, on an offer-and-sale opportunity, not on a pay-out opportunity.

Mr. LAFALCE. I understand that, but when we talk about coming to Congress for additional compensation, what insurance has or hasn't been out there oftentimes, in my judgment, would be irrelevant. You would look at the political pressure; you would look at the need. This is my perspective, and maybe I am wrong; but I will talk with you, you know, further on it.

There has been a lot of talk about the desirability of mitigation, and I don't know that this has been a primary province of the Treasury Department. I think that there are some others, whether it is the National Science Foundation or FEMA, who have been most especially concerned about this. Does the Treasury, though, believe that the mitigation measures generally can help contain property losses from natural disasters and thus help reduce potential Federal reinsurance claims? And should support for or involvement in loss mitigation efforts be a requirement for Federal disaster reinsurance for both States' disaster programs and private insurance companies?

Mr. EIZENSTAT. Before I respond directly to the mitigation, let me go back again to try to drive home why we think that although obviously there will be political pressures in both, it would be much more in the case of the cap that is in the bill. In the cap that is in the bill, people will have already paid premiums for the insurance that is out there, and they will expect a full pay-out. Under our proposal, there would be no insurance out there.

Now, obviously there will be some pressures for relief, but the fact that you don't have a paid-out amount, we think will reduce the amount of political pressure.

Mr. LAFALCE. Well, right now, when there is political pressure, it is political pressure that has not been based upon insurance being out there. Correct?

Mr. EIZENSTAT. Yes, but under the proposed legislation, you would have legislation out there and people would have already paid a premium for it and they are going to expect a full pay-out. That would not be the case again under ours.

With respect to the mitigation issue, we think that the provision in the bill, which requires that in order to be eligible to participate, a State disaster insurance program must use at least 10 percent of its net investment income to mitigate losses is sound, with two additional items that we would like to suggest:

First, that the language should require that any mitigation spending undertaken pursuant to the bill should be cost effective in its reduction of losses. In other words, it must take into account the financial interests of the State program in making the outlays.

And second, that the mitigation spending financed by the provision in the bill should be integrated with FEMA's ongoing efforts in this area.

We know that this has been a special concern of yours and Representative Maloney, and we appreciate the work that you both have done.

With respect to the broader point that you make, you are absolutely right, and this is what James Lee Witt has done in, really, I think, turning FEMA around from simply being—and I shouldn't say that this is unimportant, it is terribly important—dealing with post-disaster situations.

From 1989 through 1998, FEMA spent \$1.7 billion on mitigation activities through the hazard mitigation grant program. But what Mr. Witt and the Administration are trying to do is deal with predisaster mitigation. In our fiscal 2000 budget, for example, we have a \$30 million request for predisaster mitigation under our project impact program, which has us working at the State and local level, and in particular with communities, to make those communities more disaster resistant.

So we think that this is a very important issue. It is a way of reducing the future costs and that the FEMA work should be coordinated with this legislation.

Chairman LEACH. Thank you.

Mr. McCollum.

Mr. MCCOLLUM. Thank you very much.

Secretary Eizenstat, I certainly appreciate your being here today. I would like to emphasize that your testimony, on the whole, is very positive to going forward with legislation; and I think that your comments are on that line very, very much needed and appreciated because you recognize and have brought to our attention that the Administration recognizes the tremendous need to fill a void that is here at the moment so that consumers in the affected States ultimately have insurance products and have reasonable rates and that we don't have this void.

I wonder if you could elaborate in your own words, in a way, why and how consumers—that is, purchasers of homeowners' insurance—would benefit from the proposal that is before us and whatever form it comes out with, the details of the changes that you suggested, how and why would consumers benefit and why do we really need this legislation?

Mr. EIZENSTAT. Congressman McCollum, first, again, I want to applaud your work and leadership in this area.

I think in several ways. First, we would expect the additional Federal reinsurance to improve the availability of homeowners' insurance, in particular, to ameliorate market contractions following a disaster, where you get a real spike in prices and it takes many years for that to go down. In the interim, homeowners have less access to insurance.

In addition, we believe that the kind of limited interim Federal reinsurance program that we envision and that is in this legislation could encourage a reduction in insurance costs in many areas that would be a real benefit for average Americans.

Mr. MCCOLLUM. Well, I appreciate your summarizing that for us, because that is the bottom line. We may, and should, discuss, debate and come to some perfection of the final product; but in the end, we do have a great need for this at the moment, and hopefully it won't exist forever, but it is certainly there at the present time.

With regard to the issue of the question of availability of insurance, if you are looking at it from that standpoint and we want to have insurers make more insurance available to be sure they are

there, we need to have the program and the plan we put forward marketable; that is, that they will indeed buy the product, the reinsurance product. Do you believe that—with the new caps proposal that you have out, do you have reason to believe, from discussing with industry representatives, that the insurance industry as a whole would embrace this and find this to be, the product that we came out with, something that they want to purchase? Do you have any feel for that as opposed to the existing product?

The reason I ask that is because we know we have worked through the current language with them, and as a whole, the industry says we like it and we would buy the product. I am just wondering if your new cap proposal is something you had a chance to market through the industry?

Mr. EIZENSTAT. This is, frankly, a new idea. It is one that we want to work with the reinsurance and insurance industry on. We think that it has many advantages. First, it very clearly, as the chart demonstrates, leaves a significant area above the deductible or the trigger for the private sector, because the Government is only picking up half the difference between a 1-in-100 and 1-in-500-year event.

It has, we think, a reasonable deductible concept, very similar to that in the legislation. And it also would provide, as does the legislation, the ability to adjust the trigger so that, based on annual experience, if we feel that there is any crowding out occurring, that can be adjusted on an annual basis. And we appreciate very much that the legislation has given the Secretary of the Treasury the flexibility to do that; that is very important, and we think that that will give us a market test of whether or not we have set things at the correct level.

Mr. MCCOLLUM. Well, I appreciate it, and my only comment and reason of asking this last question of you is that from my perspective, I am very flexible about how this product is crafted, the precise terms. I think we all need to be open minded about it, but I am most concerned that we craft a product that will be purchased.

If indeed the insurance industry were to find something here it wouldn't buy, this wouldn't work. And, therefore, I think as we go through the next few days and weeks working this legislation together, you and the committee, we need to make sure that if we make this change, or a change in this direction, that it indeed is something that insurers will purchase.

Mr. EIZENSTAT. Well, we obviously share your same objective. If you have a product that doesn't sell, then you haven't accomplished anything.

We think that ours does. And, again, the basic outlines of the legislation are ones that we feel comfortable with. The areas of concern, while they are significant, are ones we hope we can work with you on and work with the industry on.

Mr. MCCOLLUM. I really appreciate it.

Thank you, Mr. Chairman.

Chairman LEACH. Well, thank you, Mr. McCollum.

Mr. Vento.

Mr. VENTO. Thanks, Mr. Chairman.

I just wonder with all the mergers of the larger insurance companies and reinsurance, if there are some antitrust or other limita-

tions that are preventing—because, you know, even other companies like Lloyds of London would run from some markets. So, you know, with the merger activity, it would be interesting to see why this isn't taking place.

One of the questions I had is, the current flood insurance programs that we now sponsor, will they be displaced or affected by this? Is this your view, Secretary Eizenstat, because they don't have a market for them today?

Mr. EIZENSTAT. No. And I think that in response to your initial concerns, the difficulty in this area, Mr. Vento, is the difficulty of pricing a risk that is so uncertain and so catastrophic.

It is not a typical risk. It is not even, you know, a 1-in-100-year flood type of risk, and I think it is that uncertainty which leads to the market gap.

This would cover hurricane, earthquake and volcano, but not flood. So it would not displace the existing flood.

Mr. VENTO. And straight-line winds, I might add, straight-line winds which we have been experiencing in Minnesota just lately. We lost a big swath through the Boundary Water Canoe Area, about 30 miles long and 15 miles wide, about 20 million trees.

Very few people live there, but it could have happened a little further south, too. It would have been different.

One of the questions that I have is the relationship between U.S. Treasury reinsurance and the relationship between FEMA and the Congress in terms of purchasing. This sort of reminds me of the crop insurance issue in which everybody—you know, just a few farmers purchased the crop insurance, but when we step in either through FEMA or through disaster assistance, everyone gets covered.

Mr. EIZENSTAT. Well, again, FEMA has largely been dealing—although again, under Mr. Witt's leadership, it is becoming much more preemptive—it has largely been dealing with the humanitarian concerns with disasters, relocating people, providing food and temporary shelter.

But it doesn't deal and can't deal with the systemic problem of the spike in rates which catastrophic events lead to which, in turn, leads in the long term to pricing people out of insurance. That is not a FEMA responsibility.

At the same time, we think it is important to work hand-in-glove with FEMA, particularly as it is trying to mitigate the likelihood of these disasters. But this is an entirely different situation which gets to imperfections in the insurance market, and that is, again, not a FEMA responsibility.

Mr. VENTO. Let me talk about one of those imperfections in the market.

The effect of the Treasury borrowing rate and what our costs would be compared to—you know, the issue here is that—what your desire to do would be to sort of atrophy as the private market developed for reinsurance, I take it?

Mr. EIZENSTAT. Well, again, we want to complement the existing reinsurance market. There is a reinsurance market; it is a very important market. We want it to grow, and ultimately we want it to be able to take this responsibility over. We think that that can occur over a period of time.



Right now, there is a gap. The gap causes a serious problem for a tremendous number of American citizens. And as some Members have mentioned, the increase in the number of natural disasters that we have seen in this decade is really quite consequential. We can argue as to why that has occurred, but it certainly is factually the case. And so we want to give time for the capital markets to develop. We have every confidence that will occur, and therefore, the kind of sunset protection that is in the bill is important.

And again, I want to stress, by giving the Secretary of the Treasury the flexibility to adjust the triggers, it gives us the capacity to make sure that if the reinsurance market is able, on a more rapid basis than one would anticipate, to fill these gaps, that there would be room to do so. The higher you place the deductible, the more the private sector can come in.

Mr. VENTO. Well, I am, you know, concerned, I think, as most are that because of the low borrowing rates at Treasury and other factors, that it just absolutely will not be able to work.

But in any case, the other questions I think that we have, the measurements over the certain amounts I expect you rely on, FEMA estimates and other factors, but another question—with time running out here—is the question of vigilance of States and private sector entities, including the insurance industry, to avoid most high risk. In other words, that is to say, today they play a vital role in terms of building codes and mitigation and other factors. By absorbing some of the risk, do we actually deter that?

Obviously, when you look at the Florida situation, you have shown us three-quarters of the loss inures to the private sector, so you would think that would be enough. But insofar as we are taking away some of the outer edge in terms of what that loss is, we are paying the last dollar on the most—well, not really the last dollar, but the last half in the example that you give for 1-in-500-year experience; there still is a significant amount of—will that affect, in fact, the motivation or vigilance of the State and private sector to mitigate possible damage?

Mr. EIZENSTAT. Well, that is the moral hazard issue, and we think that in a situation like this, when you are dealing with truly catastrophic situations and only truly catastrophic situations, that it would not in any way dampen the enthusiasm of local communities to avoid, first of all, less catastrophic events, which are more likely to occur on a frequent basis, since this only again deals with the most catastrophic; and that for those terribly catastrophic events, that is an area where there is a market gap.

And again, I would go back to what FEMA is trying to do. FEMA is working hand-in-glove with local communities to try to increase that capacity, and far from seeing—we would see no desire by local communities to reduce that. If this kind of legislation would pass, we think it would give a reassurance that those things against which, frankly, no community can protect itself, the absolutely totally catastrophic events, that this would not deter planning for things that were slightly less catastrophic.

Mr. VENTO. Thank you, Mr. Chairman.

Chairman LEACH. Thank you.

The Chair would like to make an announcement. We do have the memorial service for Representative Brown. It begins at 11:00. So

I think we should recess for that service. I would also like to announce that on the floor immediately after the service is the motion to go to conference on H.R. 10. I don't think that will take very long, but I will be obligated to be there for that brief period of time, and other Members are welcome.

Mr. McCollum will take the Chair, however, and will attempt to resume immediately after the memorial service.

Mr. EIZENSTAT. Do you wish me to reappear?

Chairman LEACH. I would be delighted if you could stay. Is that possible, Stuart?

Mr. EIZENSTAT. What time would that be?

Chairman LEACH. It would be a little before noon, I would think, we would reconvene.

Mr. EIZENSTAT. I frankly will have to check if I can get with your staff. I will do the best I can.

Chairman LEACH. We will consult with you about that.

Mr. LAZIO. I wonder if I could just indulge the committee in case Secretary Eizenstat has to go?

Chairman LEACH. Surely.

Mr. LAZIO. There is just one question I wanted to ask him, which I think is important in terms of framework, and I won't go on any further. I wonder if I could ask your indulgence just for 30 seconds?

Chairman LEACH. Yes, of course.

Mr. LAZIO. I just want to ask the Secretary this question.

One of the potential alternatives to dealing with the liquidity issue in the homeowners' insurance marketplace, Mr. Secretary, is this idea or concept of a tax fix to try to incentivize the accumulation of reserves by insurance companies with the idea that that would incentivize them, in turn, to write more insurance.

I am wondering if you are familiar with the concept and, if you are familiar with the concept, if the Administration has a position on that?

Mr. EIZENSTAT. First of all, we would be happy to work with you, and we know that Mr. Hill has also had some interest in this area. We have some serious concerns at this stage. We think it would be difficult to design an approach along these lines that limited its benefits to incremental actions, and that would not simply reward reserving that would have taken place in any event.

In addition, we have some significant reservations as to whether an approach could be adequately administrable. We think that the tax benefits are not well targeted and would not materially reduce the risk of insurance and solvency from a major catastrophic event. So it is something we are certainly willing to work with you on, but we have some very serious problems.

Mr. LAZIO. I thank you, and I thank the committee.

Chairman LEACH. Thank you very much. I am glad that the colloquy was brought in.

Mr. EIZENSTAT. I have a noon White House meeting, which I could try to have somebody else go to, Mr. Chairman.

Chairman LEACH. We will work with you during this break.

The hearing is in recess pending the memorial service.

[Recess.]

Mr. McCOLLUM. [Presiding.] The hearing will come the order. When we went to recess a few minutes ago for the memorial services for the late Congressman Brown, we were in the midst of the opportunity for Members to ask questions of Deputy Secretary Eizenstat.

At this time, I will recognize the gentleman to my left, Mr. Bereuter of Nebraska, for five minutes.

Mr. BEREUTER. Thank you, Mr. McCollum.

Secretary Eizenstat, welcome. It is nice to see you in one more capacity serving our country, and I know you will do as superbly as you have done in all of your previous work.

Mr. EIZENSTAT. Thank you.

Mr. BEREUTER. I was certainly intrigued, as other Members have expressed themselves, concerning the idea of capping the amount of insurance to be sold rather than the amount of payments to be made, and we want to follow up on that.

I also was intrigued by the information that Mr. Royce was citing, and by some of Mr. Hill's comments.

I would just advise any Members and staff, hopefully that are here, that Mr. Blumenauer and I are well on our way to trying one more effort to reform the national flood insurance program, which Mr. Vento mentioned an hour or so ago.

Mr. Kennedy and I have had two or three different efforts in the past—Representative Joseph Kennedy—and Mr. Blumenauer and I are working with Mr. Witt on that issue. So I want to inform and advise Members we may actually be able to introduce it next week.

Mr. Secretary, Section 7 of H.R. 21 relates to the auctions of contracts for reinsurance coverage, and the regional auctions whereby this legislation would divide the States into not less than six regions, but specifying separate regions for some or all parts of both California and Florida.

Now, most of the area of this country is basically exempt from catastrophic occurrences—no volcanoes, little likelihood of earthquake, no hurricanes. This is a bit of a parochial question, but I am interested in how those regions would be formed, because the great majority of the country has no dangers from those types of cataclysmic events.

For example, almost all the States in the interior of the United States would have no possibility for activities in those areas.

Now, perhaps the most violent earthquake event in recorded history, took place in New Madrid, Missouri, but I am frankly not interested in having my State or the other States of the region lumped in with that part of Illinois and Missouri that are affected by the earthquake, because it would, I assume, have quite an impact upon premiums paid and on the kind of coverage that might be available and the costs thereof.

What can you advise, if anything, about how we can assure that an isolated situation like New Madrid is not going to result in all of those States sharing in the difficulties, potential difficulties, at a recurrence of New Madrid, where there are certainly indications that there will eventually be another very large quake or series of quakes, of paying the costs associated with that very isolated part of the interior of the United States?

**Mr. EIZENSTAT.** First, if I may just mention your work on flood insurance reform, which we certainly appreciate and would encourage you to continue to work with Mr. Witt, this legislation should not affect that work.

With respect to different regions, you are certainly quite right that different regions would be affected in very different ways in any auction system or in any regional system, because some are much more vulnerable than others to these kinds of catastrophic events.

We would like to try to work with you and with the committee to see to it that States that do not suffer catastrophic events, or are most unlikely to do so, are not particularly disadvantaged in the way the regions are set up. This is, at the same time, also a State-by-State program. There is no requirement at all, it is not a mandatory program, that States have to pick up reinsurance; and presumably a State like Nebraska, that felt like it was less at risk, both its private insurers and its State program might decide that they don't wish to have this kind of protection.

**Mr. BEREUTER.** I think that is quite likely, and I would just be concerned that, in fact, the whole interior of the country really does not have a significant problem in this respect. But how those regions are drawn is something I am not sure I am willing to leave up to the Executive Branch.

**Mr. EIZENSTAT.** Well, that is why I said we will work with the Congress to try to develop that; and we certainly would welcome working with you to draw those in a fair way.

**Mr. BEREUTER.** Thank you very much.

Thank you, Mr. Chairman.

**Mr. MCCOLLUM.** Thank you, Mr. Bereuter.

**Mr. LAZIO,** do you wish to be recognized now? You would be next. Or if you wish to pass—

**Mr. LAZIO.** I will pass.

**Mr. MCCOLLUM.** I guess Mr. Weldon, you are next in order. Mr. Weldon, for five minutes.

**Mr. WELDON.** Thank you, Mr. McCollum.

I appreciate the work you are doing on this issue. As you know, it is a very important issue, not just to the State of Florida, but to many other areas of the country.

I want to thank Mr. Eizenstat for coming and testifying. I apologize for missing your testimony. I assure you that I will be reviewing it.

I would like to ask a question. I just got here. This may be a redundant question, but one of the concerns that has been raised to me, as I talk about this bill with other Members of the House, is the concern about the legislation encouraging more construction in areas that are at high risk. I want to get your opinion on that. Again, I apologize if somebody has already brought that issue up.

**Mr. EIZENSTAT.** No, it is a very good question, and I think that the best response is the following:

First, that one of the reasons we think it is important that there be, in a sense, a marriage between this legislation and the work that FEMA is doing is for precisely this reason. Under Mr. Witt's really sterling leadership, we are working with—I say, we—FEMA is working with local communities to deal with this very issue, in

advance of a catastrophe of overbuilding in high-risk areas. That is one of the key preemptive actions, so that FEMA is not simply responding in a post-crisis situation, but is also dealing in a pre-crisis situation.

Second, we do not believe, given the nature of this bill which deals only with highly catastrophic situations, talking about things that are a 1-in-100 to 1-in-500-year cycle, are likely to discourage sound land use planning in high-risk areas. Those would be going on in any event. We are encouraging them; we think mitigation is terribly important, and the simple fact that you had this kind of reinsurance program, we don't think is going to lead people to start building in improper areas because they think that in some 1-in-100-year chance that Federal insurance may pick this up.

There are sufficient incentives not to overbuild in those areas, we think, and that would be also reflected in pricing of traditional insurance.

So I don't think that this aggravates an already difficult problem. We agree it is a difficult problem and FEMA is trying to deal with that.

Mr. WELDON. In a related vein, one of the reasons why I support this legislation is, every six months or so we are passing some sort of a disaster relief bill to bail out some section of the country, and if we were to get one of those 1-in-100-year or 1-in-500-year events it could even seriously strain the deep pockets of the Government of the United States to bail out, say, a major city that were severely devastated.

Do you see this legislation as helping us prepare for that type of eventuality better? And if so, does that offset some of the concerns raised by, say, CBO scoring this thing the way they did? Then, as a corollary to that, the question I had was, what is the Administration's position on the scoring issue? Does that affect their willingness to move ahead on this issue?

Mr. EIZENSTAT. Let me give a couple of responses.

First of all, one has to consider the costs of the alternative of doing nothing, and there are very real costs. The costs of spikes in insurance rates, of less homeowners' insurance and of the potential cost of the Federal Government having to deal with the costs of stabilizing a collapsing insurance market in the event that there is a cataclysmic event, those are all very real costs and some of those can be mitigated by this.

Second, with respect to the CBO conclusion, the CBO itself observed that the budgetary impact is highly uncertain, and we are committed to a process that will yield as informed an estimate of expected losses as possible. We believe that we can develop a pricing formula that is fully protective of the taxpayer and that is free from political pressure.

Our goal and our support of any legislation would be contingent on a no-net-cost analysis.

Now, with respect to the issue of scoring, this is ultimately an issue for CBO and OMB to work out, but in terms of cost, we believe that there will be no net cost and that the pricing of these policies will take that into account and achieve that result.

Mr. WELDON. Thank you very much.

Mr. MCCOLLUM. Thank you, Mr. Weldon.

Mr. Kanjorski, you are recognized for five minutes.

Mr. KANJORSKI. Thank you very much, Mr. Chairman.

I am getting a little bit schizophrenic here, Mr. Secretary. The proponents of this legislation, to a large degree, are the very people that are constantly telling me to get Government out of and off the back of average people, and that Government can't do anything right and Government shouldn't be involved with the private sector, can't operate; and we seem to be listening to some of your testimony, and some of their questions indicate that apparently there is a great need in the United States for Government to do other things that other people aren't doing or can't do; and that the private sector seems to be not omnipotent. And I am pleased to learn that because I tend to agree that there are roles for Government to function.

But I am not sure this is one of the roles, the way this is structured. The thing that bothers me about this is that if there is such a need for the private sector to have a secondary market, and it runs to the benefit of some of the people of this Nation that do suffer or are located in catastrophic occurrence areas, I was just reading in a piece this other day that indicated that 42—no, I am sorry—38 States of the Union have surpluses now running to the amount of about \$33 billion.

Since their budgets are all in balance and they have these tremendous surpluses, and I think one of those sheets states that one of those surpluses is the State of California, I think one is the State of Florida and I think one is the State of Texas. Now, that could be because they have such gigantic economies that they are running those surpluses and they have been so successful.

Why aren't we looking at these three States that tend to suffer these catastrophic events more than other States in the Union as being much larger players and perhaps turn over to them and say, "Look, go create a secondary market for your area. You have got the funds. You are in surplus."

Why should the taxpayers of the rest of the country be involved?

Second, the thing that I really find disturbing about our private market supporters in the Congress is, they seem to lose their support when there is an immediate impact on their constituents and they want the Federal Government to rush in and to be the savior. But what about the theory that as we create an artificially subsidized secondary market we are impacting the long-term natural private market forces of where people relocate to, what type of structures they build and where population shift will occur over the United States?

It seems to me that if California is earthquake-prone, 32 or 34 million people presently exposed are an awful lot, and we shouldn't probably encourage another 10 or 20 million people to move out there to be exposed, but we are going to certainly encourage them to move out there to be exposed if we are going to underwrite their risk and underwrite the State risk and we are going to subsidize the relocation of people from the heartland of America, or from more safe areas of America, to go to more risky areas. I think we have certainly seen that in Florida.

Some of the studies have indicated to me that if we start this type of a program, even though it is now for residences, that

wouldn't solve the problem in Florida and in Hawaii in terms of commercial insurance. They are going to be back in the door the next day saying, "We need commercial secondary markets so that we can sell our hotels, apartment buildings, and we can finance our commercial operations," and they are going to want a secondary market to accomplish that, too. And that totally destroys this whole concept in America that public policy and social policy should work closer in a free market system, that money is not going to flow into areas where it is more at risk and more expensive to make that investment, and that you will have a natural barometer or protector of unusual growth if the Government stays out of it.

We are rushing right in and encouraging another 10 million people to move to Florida, and then we are coming along and we are putting \$2 billion or \$3 billion in to give them clean water so there will be enough water for those people down there to drink. We have to take care of the Everglades. I am not against it, but it is clearly—obviously these expenditures are occurring to match the unusual development desires of States like that, States like California.

Now, I think this is not well thought out at this time. I think it is premature. I don't think it covers nearly enough. It is awfully nice that Florida is going to get covered for a hurricane that occurs with secondary insurance, but as that hurricane reduces to water and just travels up the East Coast and floods the East Coast cities of the United States, those people are going to get no benefits from this type of an insurance policy because they are going to be affected by the aftermath of a hurricane, which is flooding.

On the other hand, the people that are in the tornado zone, they are not going to get any help because the tornado isn't quite as large as a hurricane or an earthquake.

It just seems to me, if our friends, the private sector supporters on the other side, really think that the private sector has failed—and I don't think they have. I agree with some of the studies that indicate there is more money in our system right now to develop a very strong secondary insurance market in this country. And it would work well, not only for residences, but for commercial development and everything else; but it would be guided off the private sector, that the prices and the ranges would occur at the risk, and it wouldn't falsely impact on social relocation in this country.

When the Government gets involved, we are going to impact falsely on social relocation in the country. We are going to be competitive with the private market and probably reduce its maturity, the speed with which it matures. But finally, we are going to put the taxpayers at risk again and certainly make people that are determined to live in distressed areas of the country, economically distressed areas, help bail out and pay for our friends that are going to bathe in the sun on islands that they should not have homes on or in locations that shouldn't have been developed originally, and where there should be a risk, but we are going to support.

I have some friends that are just going to North and South Carolina on the Banks and they are going to enjoy living in those million dollar homes that are out there that get wiped out every seven years that we pay for and subsidize so that that distressed residen-

tial portion of our population can live on sandbars that were never intended to be habitats for the human animal.

I am just wondering, is the Administration prepared to give a critique that really goes to the depths of this issue; or is the Administration going to allow our privateers on the other side to be hypocritical and inconsistent in their positions and call for Government help when they want it, and they will support their interests and their constituents in the short term? That is totally contrary to the free market system.

Mr. WELDON. Would the gentleman yield?

Mr. MCCOLLUM. The gentleman's time has expired, but Secretary Eizenstat may respond if he wishes.

Mr. EIZENSTAT. I would hope there would be an alternative between those two extremes.

I appreciate the concerns you have raised. They are all legitimate concerns, and let me try to deal with them. You raised a number of issues.

First of all, in general, in a commercial area, the Federal Government ought to be involved only when the private market fails to satisfy a need; and here we believe that there is a gap and that gap is occasioned by the inherent difficulty of private insurers and reinsurers to be able to handle the characteristics of enormous natural disasters, not your day-in/day-out hurricane or problem that occurs, but truly catastrophic situations. It is in those instances where we think the Federal is useful.

Second, that role ought to be interim, it ought to be limited, and as I mentioned, I think, before you came in, Mr. Kanjorski, that by having the flexibility of adjusting the trigger or deductible—and we would also ask that we have a similar flexibility on the cap—you can on a year-to-year basis adapt the program so that if the private sector begins to fill that gap, which we believe it will—there is now a reinsurance industry and it is growing—then the Federal role would diminish over time.

Second, you mentioned the issue of States, and you mentioned both surpluses and why should taxpayers elsewhere deal with three States. Well, we are, after all, the United States of America and what affects some States in a catastrophic way needs to affect us all.

Mr. KANJORSKI. Under devolution, you still think we are the United States of America?

Mr. EIZENSTAT. Yes, sir.

I also would urge that what happens in catastrophic events in a couple of States—and you are quite right in saying that that is where the majority of problems are, does have an impact nationwide. It has an impact in terms of cost of insurance. It has an impact in terms of diminishing the amount of reinsurance that is available for less catastrophic events around the country, because you will have drawn down the pool of private insurance to such a degree.

So this is not an isolated event for a couple of States. It will have a pervasive effect across the country.

In addition, although there are healthy surpluses in many States, due to both good fiscal management and, we think, to the remarkable economy that we have had over the last seven years of



this Administration, those surpluses, particularly when taken on a State-by-State basis, would be dwarfed by the impact of catastrophic events. That is one of the reasons that FEMA has to come in, why there is pressure for Federal emergency assistance. But it would be dwarfed, and we think that——

Mr. KANJORSKI. \$33 billion is more than what your cap is on this.

Mr. EIZENSTAT. Well, you have accumulated the surpluses in 38 States. I mean, the disaster would occur not in 38, but in one or two. So if you look at the surplus in any one particular State, it would be minuscule compared to the enormity of the costs of the catastrophes.

Then last, on the issue of subsidizing movement, I would answer in a couple of ways. First, we believe that the robustness of the pricing process in the legislation—and that we would hope to have delegated as well—will create an absence of incentives to locate or relocate to high-risk areas. It is a legitimate concern, but pricing in all insurance markets should be set according to market principles and that certainly applies here.

Second, in terms of homeowners, which is what this covers, I have to say that it passes me that a person is going to decide, or a family is going to decide, to move to Florida or to California or another high-risk area, North Carolina, simply because or even significantly because there may be a Federal reinsurance program, which I daresay most will have no idea about.

So I don't see it as a way of subsidizing movement to high-risk States but, again, the pricing process here is a very robust one and that can take care of a lot of the concern you legitimately have about building in high-risk areas.

Mr. MCCOLLUM. Thank you very much.

Your time has expired, Mr. Kanjorski.

Mr. Hill, you are recognized for five minutes.

Mr. HILL. Thank you, Mr. Chairman.

And, Mr. Kanjorski, it is interesting, hearing you argue against Government intervention and hearing my Republican colleagues argue for Government intervention. I am going to advocate for my principle, which is, the markets ought to be allowed to work.

First, let me compliment you, Mr. Secretary, on the ideas that you brought to the table here with regard to the trigger mechanism and setting the limit of insurance, changing the concept from putting limits on how many payments would be made to the amount of insurance that is sold, eliminating the concept that we would somehow prorate the payment of claims, which would be an absolutely unworkable proposition in the event there were multiple events. I think those are all good ideas, and I want to compliment you. I am not sure I am ready to embrace all elements of that, but I think that they are constructive.

I also believe we should eliminate State-by-State auctioning and go back to regional auctions and allow those States funds to compete with private markets if we are going to auction reinsurance.

The problem that I am having with all of this is that the marketplace for insurance is this: There are primary insurance companies; they are the closest to the consumer. Then we have the reinsurance

marketplace. And now we are proposing a third tier, which is a Government insurance mechanism.

If we want to have more insurance available to consumers at lower prices, then we should strengthen the primary market's ability to deliver insurance to its customers. This is kind of trickle-down economics, if I might use a term that Mr. Kanjorski would probably more often use, and that is, if we make the reinsurance mechanism work better, somehow consumers are going to buy insurance cheaper. Maybe they will; maybe they won't. But if we make the primary insurance market mechanism work better, you know that you are going to have lower cost of insurance to consumers because that is how the marketplace is working today; which is why I have proposed an idea of allowing primary insurance companies to prefund their loss reserves, which will strengthen them economically and eliminate the instability associated with the impact of catastrophes on their books of business, on their balance sheets and on their income statements.

I would just urge you again to look at that and to study the idea as we move forward.

One of the concerns I have about this whole mechanism is that in the areas where we have catastrophic exposures, we have overexposed insurance companies. That is why we were in here arguing for reinsurance. We have companies that have too high concentrations of risk, and we have an absence of competition in the market because other people don't want to enter in.

If we sell reinsurance to those companies, what we are doing is simply giving them the ability to write more insurance in a market where they are already overexposed, making them even more dependent on this Government solution.

Would you agree with that? Do you agree with that concern? Do you see that as being a potential perverse outcome of this whole thing?

Mr. EIZENSTAT. Well, I understand the concern you are expressing, and we certainly feel that it is important to have a strong primary insurance system. I am not sure that I would necessarily share the concern that you express, because I think that the pricing mechanism that will be used will act as a disincentive to overextending one's self in terms of reinsurance; and in some respects the argument you are making would apply, as well, to the private reinsurance market. I mean, it is an argument against any reinsurance. And given the layers of liability that exist with respect to catastrophic—and again, please remember, as you know—I mean, you have been a leader in this and I know from my conversations that you are highly expert—that this is not the day-to-day reinsurance situation. We are dealing with highly unlikely events of a truly catastrophic nature.

So I think the concerns you expressed will both be taken care of by the pricing mechanism and by the fact that this is a highly unusual situation, only dealing with circumstances that occur in probable circumstances.

Mr. HILL. Mr. Secretary, let me just draw your attention to one example and there is one particular insurance company that is a strong advocate of this program who, before the creation of the Florida fund and the California fund, had nearly its entire surplus

at risk under a probable maximum loss situation. And so they were very active in the creation of the California and the Florida pools, and as a consequence of that, shifted risk dramatically to those two. They laid off their exposure to those two cat funds.

As a consequence of that, were there lower premiums? No.

Was there increased capacity in those markets? No.

Was there any reduction in the exposure to FEMA in those markets as a consequence of that? The answer is no. But the shareholders more than doubled the value of their stock as a direct consequence of those two interactions by Government agencies.

Is that what we are after? Is it after rewarding the shareholders, or is it after creating a more stable insurance market, lower costs and more available insurance for consumers?

Mr. EIZENSTAT. It is certainly the latter. We want to improve the availability of homeowners' insurance. We want to encourage a reduction in insurance costs and we want to make sure that following a disaster, you don't have a tremendous contraction in the market for insurance. That, we have found by experience in Hurricane Hugo and others, does occur.

So it is certainly the latter and not the former.

Mr. MCCOLLUM. Thank you.

Thank you, Mr. Hill.

Mr. Lazio, you are recognized for five minutes.

Mr. LAZIO. Thank you very much, Mr. Chairman.

Again, I want to thank you, Mr. Secretary. I know you have had some excellent questions here and you have handled them extraordinarily well, particularly because I didn't expect that you had the depth of knowledge that you have on the issue, and so I am very impressed.

We have, as I said before, had numerous committee hearings on this subject, reported this almost identical bill out last year by a vote of 33-to-12. It was a bipartisan bill. Many of the issues that are being raised now have been raised in the past.

I just want to briefly recount why it is so important for us to act. It is not about the profitability of the reinsurance industry. It is not about the profitability of the primary insurance industry. It is about families who have settled close to or near areas that are vulnerable to natural disaster; and as I said in my opening remarks, in a couple of short years, 75 percent of our population will be within 100 miles or less of a coastline.

For somebody who loses their home in a natural disaster, who does not have the ability to insure or does not have the ability to sell their homes to somebody who can get insurance, for a lender who cannot secure their money, that would indicate a potential and likely, as a matter of fact, collapse of the real estate market, a plummeting of values, unbelievable unintended consequences as you have this devastation of value, reaching all the way to a tax base that is affected—particularly in my area, a property-tax-based area that is based on value—that you can have school districts, municipalities, terrible ripple effect through an entire community that would require, in my opinion, in the case of a very large natural disaster, extraordinary Federal intervention that affects every single taxpayer from every single State.

So I want to get away from this whole idea that it is only a few States that are affected by this. It is a national issue. It is a national issue because it affects the solvency of insurance companies at a rate throughout the entire Nation. It is a national issue because every taxpayer throughout every State in the country will have to absorb the costs of coming in and supporting a community that has been hit with a storm of the magnitude that we are talking about.

So I wanted to just to mention that and maybe get your comment on that, and also on a couple of other things. I have noticed in your comments, and I appreciate them, that you have mentioned that we are in no way in this bill trying to prohibit the growth of the capital markets in terms of providing reinsurance capacity.

As a matter of fact, I believe because of the ability for it to grow within the constraints of this bill, that we may be encouraging and do encourage the capital market reinsurance industry, and I am wondering if you can speak to that.

Let me stop there and then I will go on to some other questions.

Mr. EIZENSTAT. Thank you very much for your statement, and I ascribe to a great deal of it.

I believe it is a national problem. As I mentioned in my response to Mr. Kanjorski's question, the impact of catastrophes is not limited to just those States in which it occurs.

It has an impact to the insurance market, on the solvency of insurance, on the availability of insurance, on the availability of reinsurance all over the country. We end up picking that cost up. If we are dealing with the solvency of insurance companies, that certainly would be a national issue and that will be a problem if we continue to have the kinds of catastrophes that we have had and we don't have some kind of a program in place.

Second, with respect to the issue of capital markets, we obviously feel very, very strongly about encouraging the growth of capital markets and one of the things that we see as most positive is the growth of securitization that is occurring in this market, which indicates that there is the beginning of the development of a very healthy capital market.

Nothing that we have proposed would in any way deter that. Quite the contrary. Indeed, in the cap that we talked about, our concept of the cap where you basically are having the Federal Government pick up 50 percent of the difference between the 1-in-100 and 1-in-500 year event, you are specifically leaving that other half for the private sector as well as the deductible.

One of the positive aspects of this legislation is that by allowing the trigger to be adjusted on an annual basis, as the private market grows, so too can that deductible, and we can find private market taking over.

We also have had conversations with market participants that suggest that the standardization of contracts would actually be helpful in encouraging market development. And developing the kind of infrastructure data that will be needed to make this program work, the kind of modeling will also be helpful to the private sector because the private sector also is improved to the extent that it has good data and good information available. And developing

the modeling for pricing and so forth that will be necessary, that also will facilitate the growth of the private market.

Mr. MCCOLLUM. Secretary Eizenstat has indicated that he has to leave at 1:00. The only questioner remaining here is Mr. Royce, if he wishes to ask any questions.

Mr. ROYCE. No questions.

Mr. MCCOLLUM. Thank you for being here today and laying out the Administration position, and we look forward to working with you. Thank you again.

At this time as Mr. Eizenstat departs, I would like to introduce panel two and ask them to take their seats. On this panel is Roger Joslin, State Farm Fire and Casualty Company; Ronald Hanna, Mississippi Insurance Department; Frank Nutter, Reinsurance Association of America; Don Beery, Eustis Insurance, Inc.; Mary Fran Myers, Natural Hazards Research and Applications Information Center, University of Colorado; Travis Plunkett, Consumer Federation of America; and Jack Weber, Home Insurance Federation of America.

I want to welcome all of you to this panel today. We will begin with Mr. Joslin. We will submit your entire testimony to the record and you may summarize. Mr. Joslin, you are recognized.

**STATEMENT OF ROGER JOSLIN, CHAIRMAN OF THE BOARD,  
STATE FARM FIRE AND CASUALTY CO.**

Mr. JOSLIN. Thank you. I am Chairman of the Board of State Farm Fire and Casualty Company, the largest writer of homeowners' insurance in the United States. More significantly, the State Farm Group is the largest writer of homeowners' insurance in catastrophe-prone areas.

We appreciate and applaud the bipartisan consideration and support of H.R. 21, from the Chairman, the Ranking Member, Representatives Lazio, McCollum, Bentsen and others. H.R. 21 embodies sound principles. First, the resources of the Federal Government should come into play only very rarely, yet the trigger should not be so high that the marketplace perceives the program as an illusion.

Second, the price should properly reflect expected losses. Catastrophe-prone areas should not be subsidized. The Federal Government's contribution is the proper one because of its superior capacity to absorb the timing risk of mega-catastrophes. In analyzing the Federal Government's participation in this issue, we should not be confused by arcane insurance terminology. If the average expected annual loss is 1 percent of the nominal coverage, an 8 percent rate on-line is 8 times the annual average loss cost. I have trouble with my own staff getting them to convert rate on-line to a percentage of premium paid or to a multiple of the expected annual loss.

Third, the backstop mechanism should have certainty and continuity so as not to evaporate during or following a major event. The possibility of proration of claims during an event is very unsettling. Eliminating that uncertainty enhances the desirability of the coverage. As we know, the percentage of the U.S. population moving into disaster-prone areas is large and growing. Climatologists forecast an increase in hurricane frequency and intensity. Hurricanes threaten major population areas. Events of this magnitude

far exceed the claims-paying capacity of most private insurers serving these markets and all existing State funds.

After Hurricanes Iniki and Andrew in 1992 and the Northridge Earthquake in 1994, homeowners' insurance markets and, as a consequence, real estate markets in Hawaii and major parts of Florida and California became dysfunctional. State-sponsored mechanisms to assume and pool the most severe of these risks helped reopen markets, but they are barely able to respond to events the size of Andrew and Northridge, let alone the very possible much larger catastrophes. They would for many years have almost no ability to cope with a second event.

Theoretically there is more than enough capacity, meaning capital, in the private markets to insure or reinsure the worst of natural disasters. This theory fails in practice. Primary insurers in the aggregate have substantial capital, but relatively little of it is devoted to homeowners' insurance in mega-catastrophe-prone areas. Many companies either do not write homeowners' insurance at all or avoid catastrophe-prone areas. A few years of profitability without a Northridge or an Andrew magnitude event certainly does not diminish the need for a Federal backstop for a 1-in-100-year event. Except for one event, Hurricane Andrew, Florida's property insurance had been very profitable. That one event, however, consumed more capital than State Farm Fire and Casualty had accumulated countrywide in more than 60 years. Private reinsurance is not the answer. Reinsurers have a relatively small capital base and they must reasonably balance their portfolio, reinsure commercial insurance, provide for quota share programs, and so forth. Excess-of-loss coverage is certainly not the sole product that is available from reinsurers.

The capital markets have not solved the problem. Few financial resources have actually reached the catastrophe insurance market. Price and transaction costs have been high. And whether these securities would be available after a major event hasn't been tested. Actually, we call this a career ending decision. Who bought these dumb bonds in the first place?

Some people erroneously describe insuring for catastrophic loss as accumulating over a period of years the amount of money necessary to pay the loss. Unfortunately, a 100-year or a 10,000-year event can occur in the first year. No private enterprise can earn a competitive rate of return in the business of insurance sitting on this quantity of stagnant capital. Moreover, the United States tax policy further aggravates the problem. In most years insurance of high magnitude, low incidence events generates tax liabilities on profits that do not exist. A tax-based solution seems politically unlikely. If anything, tax policy has become less favorable in recent years. In 1997, the loss carry-back provision was reduced from three to two years and the Administration actually proposed reduction of the carry-back to a single year.

We believe H.R. 21 is a step in the right direction. It provides consumer friendly pricing for reinsurance for State funds set up to insure or reinsure catastrophic risk. The provision establishing an auction of excess-of-loss contracts is a helpful innovation. H.R. 21 could be strengthened and we are pleased that the Treasury Department suggested ways to strengthen H.R. 21 to make the pay-

ment of losses more certain under the program and to better provide for the possibility of a second event.

In conclusion, a 100-, 500-, 1,000-, 10,000-year event by definition occurs very rarely, yet it could occur tomorrow. Now is the time for Congress to act when the country is free from the trauma of a major catastrophic event.

Thank you, Mr. Chairman. We are delighted to work with you in any way possible.

[The prepared statement of Roger Joslin can be found on page 242 in the appendix.]

Mr. McCOLLUM. Thank you.

Mr. Hanna, you are recognized for your statement.

**STATEMENT OF RONALD E. HANNA, DEPUTY INSURANCE  
COMMISSIONER, STATE OF MISSISSIPPI**

Mr. HANNA. Thank you, Mr. Chairman.

I am the Deputy Insurance Commissioner for the State of Mississippi, and we appreciate the opportunity to come up and make our comments on H.R. 21.

As you know, Mississippi borders the Gulf of Mexico and has a long history with hurricanes, including Hurricane Camille, which killed 144 residents and caused \$1.3 billion in property damage in 1969. A list of the ten hurricanes damaging our State and dating back to 1893 is attached to my written comments for your information.

Along our three coastal counties, property owners have a limited selection of companies from which to purchase coverage for their homes. Six property insurance companies write 90 percent of the voluntary homeowners' policies on the Gulf Coast. Three companies write over 50 percent of the business in that area, that being State Farm, Allstate and Mississippi Farm Bureau. Their presence is vital to maintaining market stability. The State of Alabama has reported to our office that only five property companies are estimated to write 90 percent of the homes in that area.

The Gulf Coast is a very volatile insurance market. Many companies are continually changing their underwriting strategies. This cycle creates a disruptive market and reflects the underlying issues of property companies unable to commit to a consistent pattern of controlled growth. The Mississippi Windstorm Underwriting Association, a market of last resort for residents unable to obtain traditional insurance coverage, has more than doubled in size since 1993. This is as a result of tremendous growth in the area and the limitations on access to commercial insurers.

One of the most important factors in determining the availability and affordability of homeowners' insurance is the ability of the primary carrier to obtain reinsurance. Because State regulators do not approve reinsurance rates and most reinsurers are located outside the United States, I cannot provide you with firsthand reports about reinsurance markets or reinsurance capacity.

From the insurance executives I speak with, they report that the current market for reinsurance is "soft." Mississippi Farm Bureau Mutual Insurance Company is the largest property insurance company domiciled in our State, and those officials report they can buy the reinsurance than they did several years ago at a lower overall

cost. They have determined that this is due to the decrease in the number and severity of catastrophes around the world in the last several years.

However, this has not always been the case. Several years ago when a series of natural disasters occurred both here and abroad, there was great concern about shrinking reinsurance markets and the escalating prices primary insurance companies had to pay for reinsurance coverage. There is no question that a series of future catastrophes could once again affect the availability and affordability of reinsurance.

The Mississippi Insurance Department supports the efforts of Congress to enact a Federal reinsurance program. This plan should reduce the erratic pricing and availability of reinsurance which will likely result in a more stable primary homeowners' insurance market. As regulators, a stable market should be one of our most important priorities. Where there may be some technical issues with H.R. 21 that need to be resolved, the basis for the legislation is sound and we encourage the committee to move forward with enactment.

We cannot afford to have another series of insurance insolvencies similar to those which occurred in Florida after Hurricane Andrew, which were mentioned this morning. The Florida Insurance Department reported to you in recent testimony that they placed eleven insurers in rehabilitation or liquidation as a result of the storm.

It is hard to imagine the number of insolvencies we will experience if there is a 1-in-100-year storm which hits a more densely populated area of the United States. Certainly such an event would do great damage to the market throughout the country. H.R. 21 can help to address this critical issue.

Hurricanes, in most cases, are multi-State events. This means that it is likely that insurance markets in several States can be affected by a single storm. Even when the damage is confined to a single State, the effect of the insurance market can be regional as was the case with Andrew. It makes sense that there is a Federal program to deal with the problem comprehensively rather than leaving each State to handle the crisis alone.

As the committee deliberates on H.R. 21, I would like to ask you to consider a particular issue concerning the sale of reinsurance contracts sold through the Federal auction. Under the current language contracts are sold on a regional basis. Companies which only write in Mississippi, for example, would be required to purchase contracts covering losses that might occur in neighboring Alabama or Louisiana even though they write no business in these areas. A fairer option would be to allow these companies to purchase coverage priced solely on the basis of their single State exposure. This approach would be fairer to all parties, but particularly to smaller domestic insurers which might otherwise not have sufficient incentive to participate in the program. It is also important that the trigger in the bill be kept at a reasonable level for the same purpose.

In closing, I would like to commend the committee for addressing this matter, which is a real concern to the residents of the Mississippi Gulf Coast. We look forward to working with the commit-



tee in providing whatever technical assistance you may require for the success of this program. Thank you.

[The prepared statement of Ronald E. Hanna can be found on page 247 in the appendix.]

Mr. McCOLLUM. Thank you very much, Mr. Hanna.

Mr. Nutter, you are recognized.

**STATEMENT OF FRANKLIN W. NUTTER, PRESIDENT,  
REINSURANCE ASSOCIATION OF AMERICA**

Mr. NUTTER. Mr. McCollum, thank you very much. We appreciate the leadership that you and Mr. Lazio have shown on this legislation. While it may seem counterintuitive to some on behalf of the reinsurance industry, we are here to endorse H.R. 21 as the foundation for a Federal role in financing catastrophe risk. We believe that the Federal Government must be involved as a necessary component of any solution to this problem. We have expressed to you privately, and again this year publicly, the need for reexamining the capacity in the insurance and reinsurance industry and setting the triggers associated with this legislation so that you neither infringe upon the private market nor expose the Federal Government to unreasonable risk.

For those of us that are supportive of this legislation, the capacity is probably the most critical issue and I have supplied with my testimony information about the current state of the reinsurance market so that you have that information. That includes a report from U.S. Re which has been cited several times over the years as a source of information about the capacity. And they report that as of this time, July 1999, that there are \$13 to \$15 billion of excess-of-loss reinsurance being written in regions throughout the country, that you could add an additional 40 percent to that for other forms of reinsurance providing catastrophe protection per region, and in their view you could add another \$1 billion of capital market capacity being written.

Two States, Louisiana and New York, have examined this question and both have concluded that there is an overcapacity in the reinsurance market. Some have raised a question of whether or not this legislation is just about the cost of reinsurance. We have also supplied the committee as part of the testimony the trends in reinsurance pricing which show that for the ninth consecutive semi-annual period, catastrophe reinsurance pricing has dropped. Probably the best example of that is the California Earthquake Authority, which has gone to the market for both this year and next and found a 40 percent drop in reinsurance catastrophe pricing since the first year, 1997.

In our view the marketplace has worked in its classic way. Yes, there were disruptions in the Florida market after Hurricane Andrew, but what that did was attract new capacity to that market. That additional capacity caused prices to decline over time as companies competed for this business and new products in the capital market arose.

We have also pointed out that the primary market is very well positioned to deal with catastrophe exposure to a certain degree. Historically the primary market has borne between two-thirds and three-fourths of the catastrophe losses with the rest being passed

on to the reinsurance market. We cite in the testimony the Wharton study which has been referred to by committee Members as a recent release looking at their approach or their analysis of the insurance industry's ability to pay for the big one. The essence of their conclusion is that the insurance industry has more than adequate capacity to pay at least 98.6 percent of a \$20 billion loss and for a \$100 billion loss, 92.8 percent. They do talk about gaps in catastrophe risk, but what they also say is that there are opportunities here for the capital markets to fill those gaps.

We believe that the capital markets indeed are potentially going to revolutionize the securitization of catastrophe risk and should be considered by the committee.

I would also like to commend the States for what they have done in working with consumers and with the insurance industry in dealing with this problem. Many States have been aggressive about looking at options in coverage and options in deductibles and bringing prices in line with exposure which have revitalized catastrophe markets, and again the New York and Louisiana reports are probably excellent examples of that. Notwithstanding what I think is a very positive picture, there are fundamental problems dealing with the threat of a mega-catastrophe facing our country, one that exceeds the resources of the insurance and reinsurance industry and one that requires Federal involvement, and we encourage the committee to act on this legislation in that regard.

I would like to make a point about something that will be brought up on this panel and that is this concern that by raising these triggers to something as high as a 1-in-250-year event, that that is an outrageous figure. The source of that suggestion actually is from A.M. Best, which is the premier rating organization for this industry. It rates companies that are commonly familiar with A-plus companies such as State Farm and Allstate. This is taken directly from A.M. Best guidance to companies about their reinsurance programs:

"We evaluate each company's reinsurance program to determine if it is appropriate and has good credit quality. To be considered adequate for catastrophe protection, a program needs to protect a company from impairment or insolvency, from large shop losses such as a 1-in-100-year windstorm or a 1-in-250-year earthquake." In addition, before this committee last year the California Earthquake Authority testified that, this is what Mr. Knowles said, "I would say that the CEA is up and running and has dramatically reversed the problems of constricting the homeowner in earthquake markets in California and we can stand two 250-year probable maximum loss events."

The point is that it is the credit community. It is the rating community that has encouraged consideration and in fact encouraged companies to provide protection against these very high level losses. The 1-in-250 or the 1-in-100 are just statistical probabilities. They do not reflect reality. As Mr. Joslin has said, these events could occur today, they could occur three times in the next ten years, and we have to be prepared for dealing with just exactly that.

I would conclude, Mr. Chairman, with this comment. Low triggers encourage some insurers to push catastrophe risk into new

State insurance programs, and that risk will be passed on to the Federal Government. Low triggers, like low deductibles in insurance policies, raise the cost to consumers in the States. Low triggers expose the Federal Government to higher cost of natural disasters. And low triggers create incentives for Government solutions and high triggers create incentives for private sector solutions. We too look forward to working with the committee to find the right approach.

[The prepared statement of Franklin W. Nutter can be found on page 252 in the appendix.]

Mr. MCCOLLUM. Thank you very much, Mr. Nutter, for that testimony.

Mr. Beery, you are recognized.

**STATEMENT OF DONALD E. BEERY, VICE PRESIDENT, EUSTIS INSURANCE INC., ON BEHALF OF THE INDEPENDENT INSURANCE AGENTS OF AMERICA**

Mr. BEERY. Thank you, Mr. Chairman. I appreciate the opportunity to come to the committee and talk. My name is Don Beery. I am an insurance agent. I am a partner in Eustis Insurance in New Orleans, Louisiana. I also serve as the President of the Independent Insurance Agents of Louisiana. I have heard a lot of comments this morning and this afternoon about whether reinsurance is available, unavailable, cheap, expensive. All I can tell you is what the situation has become in Louisiana.

A little historical perspective about what occurred, what the State has done to kind of try and fix the problem, how it affects our customers and our agencies and basically why we think H.R. 21 is an important bill.

First of all, the first event that happened in Louisiana that had a great deal of effect on the insurance marketplace was Hurricane Betsy in 1965. Hurricane Betsy hit New Orleans with a Category 3 force, caused close to a billion dollars worth of damage and killed 74 people. As a result of that storm, insurance companies decided that nine coastal areas of Louisiana were not someplace where they wanted to put capital at risk, so they withdrew from those coastal areas.

The map, as you can see over there, there is a blue line below which is the coastal area. As you can see in Louisiana, we don't have a lot of beach-front properties. We don't have a lot of white sand. What we have is swamp and we have very few people that live in that area. The States of Louisiana came up with a mandatory residual market, pool market called Louisiana Coastal Plan, to take care of homeowners' risk in that area, property risk. That plan successfully absorbed the exposures that were in that area and it became fully populated shortly after Hurricane Betsy and remains about the same level today.

The second triggering event was Hurricane Andrew. It hit your State a lot worse than it hit ours, but after it left Florida, it came to south central Louisiana, came up through the central part of the State and affected New Iberia, Lafayette, and even got to Baton Rouge.

What happened after that was insurance companies decided to move that line a little bit further north. So we went from that In-

tracoastal Waterway line, the blue line, up to Interstate 10, and that line affects a lot more area in Louisiana and a lot more population.

About the same time as the Coastal Plan was formed, Louisiana also formed another residual market pool called Fair Plan. That plan was initially set up to cover rural properties, class 10 properties, unprotected risk, and some urban properties that at that time were not being properly serviced.

Well, what happened to the Fair Plan was all of a sudden they were asked to take on this additional risk of those unwanted homes that were left in the wake of Hurricane Andrew. My understanding was at that point the reason why companies pulled back was principally a reinsurance question. But what has happened is that pool, the Fair Plan, has grown by 800 percent since 1993. It still averages a thousand new policies a month. That is an awful lot of policies that are going out of the voluntary market.

Again, I don't know whether reinsurance is available or not, but it seems to me if it was readily available and it was inexpensive, the regular markets, the voluntary markets would be in there. The frightening thing that comes down the road from this is that should another storm come in, those are pools. The insurance companies that write business voluntarily in the State are in there for the profits and for the losses. So if another storm comes in, there is going to be a tremendous assessment of those companies which could cause some insolvencies and other problems.

Another thing that I think that drives a part of this is this hurricane computer modeling. I question sometimes—in the past, these big catastrophic events have been the things that you dread and you wake up in the middle of the night and you worry about. I think these models bring it home like it is a real thing. And when insurance companies can see on their model what happens when a Category 5 storm comes up the mouth of the Mississippi River and how much they have at risk and how much they are going to lose, I think it makes it almost like a real event to them and causes some overreaction in terms of what they are willing to write and what they are willing to do in the areas.

I think all of this brings to bear the need for this H.R. 21, for some form of Federal catastrophe reinsurance. I think that the current bill is good. It is fair. It allows for no discrimination among the different areas involved. I like some of the suggestions that were brought up by the Deputy Secretary of the Treasury this morning. I think that it has a lot of potential.

I think that, in closing, I would like to reiterate the problems of Louisiana and other States are real, they are not made up. Over the last eighteen months you have heard from insurance agents from around this country as to what their personal war stories are. We have got a lot of them in our agency. We have some homeowners now that we are placing with Lloyd's of London, which to me in my 30 years in the business I never thought we would be insuring homeowners in Lloyd's of London.

I think that the passing of H.R. 21 will restore some confidence in the insurance markets, force more business back to the private insurers and improve the quality of coverage for our customers. We urge you from Louisiana to do this and we have the support of not

only the agents, our customers, but also the Insurance Department has recently sent a fax to the Louisiana delegation indicating that they are behind this bill also.

[The prepared statement of Donald E. Beery can be found on page 277 in the appendix.]

Mr. MCCOLLUM. Mr. Beery, I really thank you for bringing that up and I think you and Mr. Hanna have illustrated the problems in the coastal areas along the Mississippi and in Louisiana and that whole Gulf Coast area, and I appreciate your coming all of the way here to do that.

Ms. Myers, you are recognized.

**STATEMENT OF MARY FRAN MYERS, CO-DIRECTOR, NATURAL HAZARDS RESEARCH AND APPLICATIONS INFORMATION CENTER, UNIVERSITY OF COLORADO**

Ms. MYERS. Thank you, Mr. McCollum. Thank you for the opportunity to speak with you today. My name is Mary Fran Myers. I am the Co-director of the Natural Hazards Research and Applications Information Center at the University of Colorado. We are a federally-funded organization, funded by a consortium of Federal agencies, including FEMA and the National Science Foundation, to serve as a national clearinghouse for research data on all natural disasters and programs to reduce damages from them.

Our main mission for the past 24 years has been to bridge the gap between the hazards research community and the Nation's practitioners who deal with hazards on a daily basis.

In May, we released the results of a federally-funded five-year, \$750,000 study involving 132 of the Nation's hazards experts. It is called "Disasters by Design," and the Federal funding came from the National Science Foundation, FEMA, the U.S. Geological Survey, the U.S. Environmental Protection Agency, and the U.S. Forest Service.

This team of experts took stock of all knowledge in the physical, natural and social sciences as well as the specialties of engineering regarding natural hazards to answer the question why, despite all of our knowledge about natural hazards, about the causes of, consequences from and remedies for disasters, our losses from extreme environmental events continue to rise at an ever-staggering rate. I am providing each of you with an executive summary of the book today, and I want to mention only a few highlights from the study itself. However, I ask that the entire executive summary be recorded as part of this official hearing.

[The information referred to can be found on page 285 in the appendix.]

Losses from natural disasters are continuing to rise because our hazard reduction programs have been too narrowly focused on simple loss reduction. They fail to comprehend the complex and broad range of factors that contribute to disaster losses, specifically elements within the Earth's physical environment, among the Nation's ever-changing demographic composition and disposition, and within the growing density of our built environment. These factors interact with one another to affect not only disaster resiliency, but the other aspects of our sustainable society as well.

The conclusion of our five-year study was that current loss reduction and mitigation programs are shortsighted and too reliant on technology. It is clear that these efforts, rather than reducing losses, are actually only postponing catastrophic losses to future generations, much as we postpone our national debt.

Our study underscored that it is human beings and not nature who are the cause of disasters. Unless hazard loss reduction programs, be they proper land use planning, disaster relief programs, building codes or insurance programs, also take into consideration other basic aspects of sustainability such as economic vitality, environmental quality, and inter and intra-generational equity, they are doomed to fail.

Our study calls for a change in national culture regarding natural hazards in order to achieve a new way of dealing with extreme environmental events, and we call this changing culture sustainable hazard mitigation.

In order to make that approach possible, several extraordinary actions are required, some of which are being initiated right now. The Deputy Secretary this morning referred to much of the work that FEMA is doing. For example, through its Project Impact Program, FEMA is providing leadership by facilitating consensus based networks in communities where citizens are determining which disaster losses are acceptable, which are not acceptable and how they are going to pay for those in the future.

In other words, they are working on designing their future disasters. That is but one action—the building of consensus-based networks and communities—that our project is recommending. There are several others, but I want to mention two of them specifically.

One is the need to measure progress and evaluate current mitigation programs. For example, as has been referred to this morning, the National Flood Insurance Program, arguably the Nation's largest mitigation program, has been in operation for 31 years in this country, yet its effectiveness has never been thoroughly appraised. We only know that floods continue to cause the most damage from any hazard in this Nation.

Second, we are calling for a holistic Government framework to facilitate sustainable hazard mitigation. All policies and programs, especially at the Federal level, need to be integrated and consistent. To go ahead to establish a new national policy that affects hazard mitigation without considering its impacts on our complex society and the broad range of other mitigation strategies simply continues the Band-Aid approach to dealing with disaster problems that this country has traditionally pursued.

Our study determined, however, that disasters are not problems. Rather they are a symptom of broader and more basic problems. Losses from hazards result from shortsighted and narrow conceptions of the human relationship to the natural environment.

Thank you for the opportunity to speak. I will be happy to answer any questions, but I also want to volunteer the resources of our center as you continue consideration of this bill.

[The prepared statement of Mary Fran Myers can be found on page 283 in the appendix.]

Mr. McCOLLUM. Thank you very much, Ms. Myers. That is an impressive study and we thank you for your testimony.

Mr. Plunkett, you are recognized.

**STATEMENT OF TRAVIS PLUNKETT, LEGISLATIVE DIRECTOR,  
CONSUMER FEDERATION OF AMERICA, ON BEHALF OF J.  
ROBERT HUNTER, DIRECTOR OF INSURANCE, CONSUMER  
FEDERATION OF AMERICA**

Mr. PLUNKETT. Good afternoon. My name is Travis Plunkett, and I am Legislative Director with the Consumer Federation of America. I will be offering comments today from Robert Hunter, who is our Director of Insurance. Unfortunately, he cannot be here today.

Thank you for the opportunity to be here. We would like to start by saying that CFA sees the current reinsurance situation as an implication that no bill may be necessary at this time. The predicate for this bill may have actually been eliminated by normal market forces at work. In the July 12 *National Underwriter*, Mr. Peter Porrino, former Chief Operating Officer of Zurich Reinsurance and currently the National Director of Ernst & Young's insurance industry practice, said that capital markets and securitization have placed a permanent cap on the pricing of catastrophe reinsurance. He said that the reinsurance industry wouldn't again see the hard trends that followed 1992's Hurricane Andrew and 1994's Northridge Earthquake. In the same article a J.P. Morgan analyst is quoted as saying that the reinsurance industry is overcapitalized by about \$75 billion at the same time USAA and other insurers have been protected by new securities market based reinsurance arguments.

It has been clear for some years now that this bill really only would affect State Farm and perhaps Allstate insurance companies in a significant way. These companies, through diversification, balance in their portfolios of risks insured, and in State Farm's case massive overcapitalization are no longer really in need of this bill either. So we would like to start by congratulating the Members of the committee for their patience over the years and for not overreacting to insurer pressure to enacting an unnecessary intrusion into this area being well handled by the private sector.

However, that doesn't mean that there is not a need to consider the current system for insuring against disaster. Right now we have the time to do what is needed in the disaster insurance area, rationalize the system that is so inconsistent today. America has allowed its system for preparing and responding to natural disasters to grow in a haphazard way that inconsistently deals with natural disasters and which inadequately acts to save lives and property damage from natural hazards. Let me just give you a couple of examples of this inconsistency.

Insurance takes care of smaller wind events such as tornadoes almost completely. Insurance also does a good job on large wind events, thus the relatively low need for disaster relief for damages from hurricanes compared with the large need for relief for the less insured hazard of earthquakes.

The issue of State cross-subsidies is also important to consider. Our written testimony goes into this at length. Exhibit 4 of that testimony shows an estimate of the subsidy by State in dollars per household per year. The largest subsidies go to North Dakota and California. States paying the most are Connecticut, New Jersey,

and Florida actually had a relatively low subsidy considering that Hurricane Andrew occurred during this period of study. This is because the people of Florida are paying their own way with insurance premiums for wind.

There are a number of questions we urge the committee to ask as you consider our crazy quilt disaster system, such as given the current overcapitalized insurance and reinsurance markets and the ready availability of catastrophe reinsurance, do we really need a Federal backup for any hazard? If so, should the program be limited to earthquakes only? What form should the program take? USAA has proposed an idea deserving of study, a program of tax deferred reserves to maintain catastrophe risk in the private sector while ensuring access to affordable insurance to consumers.

Insurance company reports indicate that damage caused by Hurricane Andrew would have been a one-third to one-half less if building codes then on the books were enforced. Perhaps national verification of building code enforcement would be remarkably useful should there be such code verification.

The issues of subsidies under H.R. 21 and how they might change from State to State should also be evaluated. Finally, we would add ours to the number of voices that we have heard this morning urging the committee to look hard at the Wharton School study and to ask them in to testify, because we believe that that study answers a number of the questions that we have posed. Ultimately if we can find the right balance of mitigation, tax deferral response, insurance risk securitization and enforcement, we can devise a plan to pay for the current natural disasters and plan for future ones in a way that demonstrates to the taxpayers in such States as Connecticut, New Jersey, New York, Massachusetts, Ohio, and so forth, the States that are currently footing the costs of disaster relief, that they will be freed from today's cycle of higher and higher tax support of unwise construction in high-risk areas of the country.

Thank you for this opportunity to testify.

[The prepared statement of J. Robert Hunter can be found on page 297 in the appendix.]

Mr. McCOLLUM. Thank you very much, Mr. Plunkett.

Mr. Weber, you are recognized.

#### **STATEMENT OF JACK F. WEBER, PRESIDENT, HOME INSURANCE FEDERATION OF AMERICA**

Mr. WEBER. Thank you, Mr. McCollum. It is not surprising that at the end of the day you and Mr. Lazio are both still here with us. You have been with us from the start in looking at this issue and we want to express our gratitude for your dedication to this effort in making sure that this legislation gets done and gets done right. A couple of points that I would like to make. Before I do, we have two documents in addition to my testimony that I would like to have included in the record.

One is a document, "The Case for a Federal Disaster Reinsurance Program," and the other is a response to some issues dealing with the capacity in the reinsurance market and such and I would like those included in the record.

Mr. McCOLLUM. Without objection, so ordered.



[The information can be found on page 316 in the appendix.]

Mr. WEBER. Thank you. I would like to talk about a couple of the issues that have been brought up today and try to set the record straight on a few of them, maybe clear up some misunderstandings. The first is having to do with the trigger. There has been much discussion about the triggers in this legislation.

As you know, there are three tests for the trigger in the legislation: One, that the event which occurs has to occur less than once every 100 years. The second trigger is that it must exceed the level that current State programs have for dealing with these events. In other words, the trigger must be above the capacity of State programs. The third number, which I think has been greatly mischaracterized, is the fact that the trigger should never be less than \$2 billion.

I think it is important to keep in mind that when you look at the States that have these catastrophe exposures, that most of the triggers in this bill are well beyond \$2 billion. For instance, Florida's 1-in-100-year event trigger is a \$21 billion residential insured loss, not \$2 billion.

In California the trigger is approximately \$7.5 billion of residential loss, not \$2 billion. The \$2 billion figure was inserted in this legislation largely to deal with extremely small States that clearly do not have the population or the premium volume to deal with very large events and the most relevant place that that applies would be the State of Hawaii. They have a program that was instituted after Hurricane Iniki, buying reinsurance from the private market using bonding capacity. They still only have a \$1.5 billion capacity. So that \$2 billion figure does not apply in most areas of the country.

Second, I would like to point out that a lot has been made about concerns about this legislation interfering with the private markets and particularly the private reinsurance markets. I would like to just point out some of the provisions that the committee inserted into this bill last year to deal with that very subject, many of which were put in by those that were concerned about this subject.

In Section 3 the bill restricts the authority of the Secretary of the Treasury to offer Federal reinsurance contracts which would in any way displace or compete with the private insurance and reinsurance markets.

In Section 6 the bill limits the eligibility of State programs for Federal insurance to plans which do not supplant coverage that is otherwise available in the private market.

In Section 7 the bill authorizes private rereinsurers to purchase Federal reinsurance contracts and further allows such contracts to be transferable, assignable and divisible. This means that a reinsurer can buy these contracts and actually use them to increase their own capacity in serving the private market.

In Section 8 the bill authorizes the Treasury Secretary to reduce the levels of Federal reinsurance, as has already been mentioned today, to 50 percent, so that even when the triggers are met, the Federal program is only covering 50 cents on the dollar of eligible losses.

I would also like to mention a point that was raised and touched on today, which has to do with the capacity of the private reinsur-

ance market and the pricing of reinsurance. For instance, it has been alleged today that the prices for reinsurance in fact have been coming down. That is true. Reinsurance rates are lower this year than they were last year. However, that characterization of the reinsurance market and the pricing is also misleading because in this decade reinsurance rates are still up a net 60 percent. They were up 120 percent after Hurricane Andrew. They have since come down by about 35 percent, but the net increase over the last decade is up 60 percent.

Another point that has been made is that the reinsurance capacity in the private market is in the neighborhood of \$20 billion per region. And we reject that categorically and let me tell you a couple of the reasons why. First, the figure \$20 billion, even if it were true, applies to all types of reinsurance sold, not just reinsurance made available to the homeowners' insurance industry. Almost one-half is devoted to commercial lines which are not covered in this bill. So the \$20 billion figure has to be cut in half simply to allow for the issue of commercial lines which are not covered.

Second, much of the estimate for reinsurance capacity involves double, triple and quadruple counting of reinsurance capacity. Let me give you an example. One of our member companies purchases a layer of reinsurance for their hurricane exposure in the Northeast. It is in the range of about \$400 million. It is for hurricane exposure in the Northeast, but because they are a national company, that reinsurance capacity is theoretically available anywhere that they do business. And when the so-called experts who are estimating the reinsurance capacity count up those numbers, they look at that company that has bought that \$400 million of reinsurance for the Northeast and they also say "Well, because that is in place in the Northeast and it is a national company, it is also in place in California, and it is also in place in New Madrid, and also it is in place in the Pacific Northwest, even though none of those places are ever going to have a hurricane." So in other words, the \$500 million of the \$400 million of reinsurance that is being purchased is being assigned to the West, the New Madrid area, the Gulf Coast, even though it is really not practicably being used there.

Finally, the issue of the ability of the insurance industry to cover these losses. The surplus of the property and the casualty insurance industry has been estimated in the range of about \$300 billion. That is all insurance companies, that is not the insurance companies that write homeowners' insurance business. In fact, approximately 80 percent of the homeowners' insurance business that is written in this country is written by ten insurance companies. Those ten insurance companies have a surplus, which is a small percentage of that \$300 billion figure. But what is more, most of the surplus of the companies that do write that business have derived their surplus, not from homeowners, but from auto insurance. The typical company that is a member of the Home Insurance Federation, their premium volume is essentially divided as follows: 80 to 85 percent is auto insurance and 10 to 15 percent is homeowners' insurance.

It is incredible to us that anyone would argue that a company that is generating only 15 percent of their income and profit from homeowners' would put their entire company at risk from a home-

owners' peril: That is why companies are pulling out of the market in those areas where they feel that that surplus is that extreme risk. There are some other points that maybe we can take up in questioning. I know my time is up.

[The prepared statement of Jack F. Weber can be found on page 310 in the appendix.]

Mr. McCOLLUM. Thank you very much, Mr. Weber. I will yield myself five minutes.

There have been a number of questions that have been raised by the panel and I would like to clarify a few things on my limited time.

Mr. Nutter, you suggested that A.M. Best had proposed, or perhaps the idea of the 1-in-250-year event came from them, and then you laid out their comment about 1-in-100-year event for a windstorm, and a 1-in-250-year event for earthquakes.

I had previously had the impression that the suggestion being made to us by perhaps you and others to change our 1-in-100-year event to 1-in-250 was for both windstorm and earthquakes. This sounds like A.M. Best is suggesting perhaps that might be bifurcated. Is that what I am hearing you say today?

Mr. NUTTER. What I cited is from the A.M. Best study that when they evaluate companies and look at their reinsurance programs, those are the standards they expect those companies to meet. You are correct that what I said is that Best looks at those separately. And I cited it primarily because there was some suggestion that a 1-in-250-year event was a ludicrous number. In fact, it is a pretty common number by the industry's premier rating organization for earthquakes and the 1-in-100 for hurricanes.

Mr. McCOLLUM. Also in regard to Mr. Weber's last point, I believe in your testimony, Mr. Nutter, you cited that \$13 to \$15 billion in excess-of-loss capacity in the catastrophic reinsurance area per region per event. Mr. Weber was citing \$20 billion. I don't know what the actual number really is, but I am curious to know what, of the figures that you gave us, the \$13 to \$15 billion, is focused on residential versus commercial? Is that all residential you are giving us or does that include commercial and residential?

Mr. NUTTER. The catastrophe contracts are generally written to cover both risks. So what Mr. Weber raises is a red herring. He is citing the fact that what has happened in past events is that the losses have been both residential and commercial so the losses themselves, as you would expect, cover both residential and commercial. If a hurricane went through a totally residential area, a property catastrophe reinsurance contract would cover those losses whether they were residential or commercial.

So it is not a matter that the contracts are written to distinguish between the two. The contracts are written to cover the losses associated with an insurance company. They may be all residential. They could be all commercial as well.

Mr. McCOLLUM. I think the point is well made on both counts, but I do think the key is as we write this, your industry has said and you said at the beginning of your testimony, we need a Federal reinsurance program. It is a question where it enters, at what point. I want to assure you that we do not want to crowd out any private reinsurance market which is why the relief provisions are

in here. We want to work with you to make sure that we don't do that whatever way we do it, and yet we still have to have a product that markets.

Mr. Joslin, there has been some discussion here and I think perhaps that was brought up by Mr. Plunkett in his testimony from Mr. Hunter from the Consumer Federation about capital markets and that there is an indication that there is sufficient capital markets out there. Secretary Eizenstat said that there were some incipient capital markets coming along and he hoped that this would help this process down the road so that we don't have to have this program forever.

I gather from his testimony that the optimistic view of the Consumer Federation on this point is not shared widely. How is the capital market situation as you see it today for this purpose?

Mr. JOSLIN. I think anyone who has ever had a bright idea in this area has made a sales call on us. We have found that it tends to be problematic. They are coming with an idea, but not necessarily with investors behind them. There have been transactions that have taken place, real transactions. The cost tends to be higher than reinsurance. As much as we may kick at the reinsurance people, the costs tends to be higher, and they clearly have much higher transaction costs. So it is developing. They are finding some formats that may work, but it is just not an awful lot that is showing.

Mr. MCCOLLUM. I don't know if it is more or not, but what I am aware of is only one deal in 1998 worth \$2.5 billion to securitize catastrophe risk in the capital markets.

Mr. JOSLIN. Excuse me, sir. There are a whole handful of smaller transactions. I am aware of two larger transactions in which the primary insurer actually felt that they were subsidizing the program just to try to jump-start the market.

Mr. MCCOLLUM. So it is beginning to develop, but we are not there yet. By no means is that something that we should consider to say don't do this bill; am I correct?

Mr. JOSLIN. I think the answer is absolutely not. I view the availability of the excess-of-loss contract concept as something that can support the capital markets and support reinsurers in their programs as opposed to the other way around.

Mr. MCCOLLUM. You are yielded five minutes, Mr. Lazio.

Mr. LAZIO. Thank you very much. I want to thank the entire panel for their testimony. All of it was very good.

Let me, Mr. Beery, because I know you are so familiar with Louisiana, and those diagrams which are very compelling. Louisiana has a Fair Plan, does it not?

Mr. BEERY. Yes.

Mr. LAZIO. Can you describe what that is?

Mr. BEERY. The Fair Plan is a mandatory State pool. The original concept was that it would insure, be market of last resort for country properties, unprotected Class 10 fire district properties, and also for some urban intercity properties that couldn't find insurance. And then after Hurricane Andrew when companies started to pull out of the areas that we indicated on those maps, the Fair Plan was a mechanism that stepped in and provided coverage to those people who found themselves unwanted as homeowners.

Mr. LAZIO. Otherwise they would not be able to get insurance?

Mr. BEERY. Right.

Mr. LAZIO. What has happened in terms of enrollment in these Fair Plans in Louisiana?

Mr. BEERY. The increase has been like 800 percent since they started to use it since Andrew, and 1,000 policies a month are the average increase for the last few years. It is overpopulated, and it is frightening.

Mr. LAZIO. So these folks would not have any risk management at all but for this Fair Plan?

Mr. BEERY. There would be an absence of it, that is correct.

Mr. LAZIO. Mr. Joslin, I want to address this to you, because I think it is somewhat related. You are the Chairman of an exceptionally large insurance enterprise which has a long reputation, and yet State Farm Fire was technically insolvent after Hurricane Andrew and after the Northridge Earthquake. Is that true, and can you tell me how that is possible?

Mr. JOSLIN. We hate the words, but the answer is it is true for Andrew, because we had a very large exposure down there. We had frankly underestimated the exposure of the probable maximum loss, or even an intermediate level loss, which is probably closer to what Andrew was. State Farm Fire and Casualty simply did not have sufficient capital. Fortunately, it was able to call on the resources of its larger parent, and we have now established an intra-group reinsurance plan to provide additional capital on a contractual and permanent basis, but it still is a situation whereby we simply cannot write all of the business that is available in South Florida.

Mr. LAZIO. Let me turn to Mr. Nutter. I want to thank you for your testimony and for your general support for H.R. 21. I know you have some reservations.

I just want to ask you a bit about the fact, the contract aspect of this and do you think reinsurers would participate in these auctions of the contracts and is some of your concern or a good deal of your concern mitigated through the modification of H.R. 21 that would effectively create a co-payment structure for losses above the trigger level?

Mr. NUTTER. The answer is yes to your question. I do think, and I know our companies believe that the excess-of-loss contracts would be attractive to reinsurers, that they would use them to add capacity to the market, that they would be a vehicle, as Mr. Weber says, to facilitate additional capacity to their client companies.

And yes, the 50 percent co-pay that was proposed by Treasury is an attractive feature to limit the impact that this legislation and the proposal might have on the private markets.

Mr. LAZIO. The part that is in the existing bill now as a result of last year, this co-pay provision, you find attractive?

Mr. NUTTER. Yes.

Mr. LAZIO. If I can, Mr. Chairman, I may not be able to be here for the whole hearing. It is my youngest daughter's sixth birthday today. I want to apologize to the last panel if I am not here. It is not a lack of interest or lack of respect, it is only trying to keep my priorities in order.

Mr. McCOLLUM. Thank you very much, Mr. Lazio, and that explanation is good.

Mr. Royce, you are recognized for five minutes.

Mr. ROYCE. One of my observations, Mr. Chairman, if the tax code were changed to allow for the accumulation of reserves without tax penalty I think we might be able to devise a solution to this, and I understand the concerns that we wouldn't be able to get that through, but I think it is a point that the private market could provide a solution in theory if it were not for the fact that the tax code imposes this penalty on accumulation of reserves.

Let me ask Mr. Nutter. In your testimony you mentioned two recent published studies that have found that there is \$20 billion of catastrophic reinsurance capacity available per region per event, and you state that this number does not include the capacity provided by the primary insurance market. In your view, how much more in additional capacity would be added to that number by the primary insurance market?

Mr. NUTTER. That is a good question, Mr. Royce. The studies were our requests to participants in the marketplace to look at actual contracts in place, and I do not think that, as Mr. Weber has suggested, that there is any double counting there at all. They certainly were looking at actual contracts covering certain regions.

I probably don't have a specific answer to your question about the ability of the primary industry and what their capacity is, but I would say this. In Hurricane Andrew about one-third of the losses that were paid in the net event were paid by the reinsurers, meaning two-thirds of the losses were picked up by the primary industry.

In the Northridge earthquake, about one-quarter of the losses went to the reinsurance industry and three-quarters went to the primary industry. My guess is, those numbers, that range, would give you some sense of what the primary industry would expect to pay in an event that was large to exhaust the reinsurance capacity. So those are the only things that I would really have to go on.

Mr. ROYCE. OK. Thank you. You are also advocating that the trigger levels in the bill be raised from the current level of \$2 billion or 1-in-100-year event to the new level of \$5 billion or a 1-in-250-year event.

Now, in the other testimony, some have complained, even said they are flabbergasted that this threshold of 1-in-200-year event would be argued. They say that is unreasonable, one of the panelists anyway.

Would you explain the 1-in-200-year event again to us, and is this something that a company can prepare for? Give us again your analysis on that, if you will.

Mr. NUTTER. Sure. The comment that I made earlier was that the industry's premier rating organization does, in fact, expect companies to fund their catastrophe exposure with reinsurance for a 1-in-100-year hurricane or a 1-in-250-year earthquake, a very realistic number that, frankly, is available to the private market.

The suggestion has been made that a 1-in-250-year is somehow an outrageous number. We looked at the top ten catastrophes that have occurred in this country over the last 100 years, adjusted the numbers to 1997 dollars to determine whether a program of this

nature would trigger at a 1-in-250-year event, and found that four of those ten largest events would in fact have triggered a program, one might have, and five probably would not have, but probably would have been covered in the private market.

And I also cited the California Earthquake Authority that testified last year that said that they believed they were covered for 2-in-250-year events. So it is a realistic number, in our view, about what the capacity of the market is to provide this coverage and what the ratings organizations expect the industry to cover.

Mr. ROYCE. And in closing, what would be the consequences of a \$2 billion trigger again, in your view?

Mr. NUTTER. Our concern is that low numbers, like 1-in-100 or \$2 billion, provide incentives to States to create State funds and have insurers roll the risk into State government programs that then would roll into Federal programs.

Mr. ROYCE. And that drives up costs, arguably? How does that drive up costs?

Mr. NUTTER. It is just like a deductible in your insurance policy. If you ask for a low deductible on your insurance policy, your premium is higher; if you want a higher deductible, your premium is lower. It is the same thing with these triggers.

Mr. ROYCE. So overall, for all intents and purposes, it just increases the costs on the society?

Mr. NUTTER. Low triggers would increase the cost to the Federal Government in paying claims. It would increase the costs to those who purchase the contracts.

Mr. ROYCE. Thank you.

Thank you, Mr. Chairman.

Mr. MCCOLLUM. Thank you very much.

Mr. Hill, I will recognize you. We are going to have to have a recess pretty quickly, though, because I want to make this vote and I know you do, too.

Mr. HILL. OK.

Mr. Weber, presuming that H.R. 21 passed and it passed in its current format, the clients that you represent, the HIFA people, have they given any indication to that they would write more insurance in the catastrophe-prone areas of the country?

Mr. WEBER. Yes, as a matter of fact, they have.

Mr. HILL. OK. Would they write more insurance in the areas that Mr. Beery has discussed, the areas that are now blue-lined in Louisiana, the coastal areas? Could we expect that—I think that group of insurers write 50 to 60 percent of the homeowners' insurance in the country. Could we expect that they would write 50 to 60 percent of the homeowners' insurance in that area?

Mr. WEBER. Well, I believe that they are already writing a substantial part of the business. You know, I can't speak to specific market shares, but I think that the point is—

Mr. HILL. But they would write more insurance in those areas?

Mr. WEBER. They would write a prudent amount of business, yes.

Mr. HILL. So you would have no objection, if there is a requirement in the bill in order to participate in reinsurance, that they do write insurance in those areas?

Mr. WEBER. I think that it would be a mistake to dictate to any company what their specific business practices or plan would be. I don't think we would do that with any other company.

Mr. HILL. If there is a requirement to have a Government subsidy for insurance, wouldn't it be appropriate for them then to make some commitment to write insurance?

Well, let me ask Mr. Joslin, if we pass H.R. 10, will State Farm write a larger proportion of insurance in Mississippi, the area Mr. Hanna has talked about; the North Carolina coastal area, the area that Mr. Beery is concerned about?

Mr. JOSLIN. Let's start by backing up just a tad, where you said if the Federal Government subsidizes the writing of insurance, it would be reasonable for insurers to write more. This bill does not call for the subsidization of primary insurance.

Mr. HILL. Let's not debate that. Let's go to the specific question.

Mr. JOSLIN. OK.

Mr. HILL. Will you write more insurance in the areas that Mr. Beery has described or Mr. Hanna has described, that we had earlier testimony, in the North Carolina coastal area if H.R. 21 passed?

Mr. JOSLIN. I think almost certainly we would write more insurance. I think what would be even more important, though, is that we would find that other insurers would come in and make for a more competitive market, which I think is good for the consumer.

Mr. MCCOLLUM. Mr. Hill, I am going to interrupt because we have less than two minutes to go for a vote. I am going to need to recess.

Do you want to try to come back for this panel?

Mr. HILL. I would like to, yes.

Mr. MCCOLLUM. If you want to finish this yourself and take the risk, it is up to you.

Mr. HILL. No, I will go vote.

Mr. MCCOLLUM. All right. We will be in recess. If the panel can stay, fine, but you will be the last questioner. We will be in recess.

[Recess.]

Chairman LEACH. [Presiding.] The hearing will reconvene. Mr. Hill is recognized for a continuation of his questioning.

Mr. HILL. Mr. Joslin, I certainly wasn't trying to pick on State Farm. My point simply is, I am having a hard time understanding how H.R. 21 is going to translate into more retail-level, primary insurance available.

I think, Mr. Nutter, you made the point that two-thirds to three-fourths of catastrophic claims are paid by primary insurers, and if we want to increase the availability of insurance in catastrophic areas, then we need to increase the availability of primary insurance in catastrophic areas. I mean, that is what we are trying to do with our alternative plan by allowing companies to prefund their loss reserves.

But let me just ask you a couple of questions, because there is a whole debate about whether there is subsidy involved. You are concerned that one of the things that is going to happen with these low triggers and perhaps too-low-priced insurance is it will crowd out private reinsurance; is that correct?



Mr. NUTTER. Yes, that is correct.

Mr. HILL. There certainly is a tax advantage to all of these State pools. In fact, this Treasury plan, there will be no tax on the premiums that are paid to the Treasury because it will be a tax deductible expense; there will be no tax paid on the income stream and all the State funds, I believe, are tax-exempt entities. So there is a tax advantage to all of these States funds and State pools in this Treasury plan, isn't there?

Mr. NUTTER. Yes.

Mr. HILL. And also there is a cost-to-capital advantage. I mean certainly the U.S. Treasury can get capital cheaper than any one of the insurance companies that are out there. In fact, some people are suggesting there is no cost to capital here; but those would create competitive disadvantages to the reinsurance industry, or at least potentially could, wouldn't they?

Mr. NUTTER. Absolutely, which is why we have argued for higher triggers to have this program operate only at levels that the private market is really not capable of providing coverage.

Mr. HILL. If the Chairman would indulge me for one last question, the debate is over whether there is a \$21 billion exposure in Florida or it is \$14 billion, but I would just draw from the example—and correct me if I'm wrong.

Let's say it is \$21 billion, as Mr. Weber has suggested that it is and that traditionally two-thirds is covered by primary insurance which would be \$14 billion; and let's say that the \$14 billion, of the regional reinsurance, is only half applied to residential insurance, my addition of 14 plus 7 is 21, which would cover the likely loss. Is there anything wrong with that math?

Mr. NUTTER. No, I can't find anything wrong with your math.

Mr. HILL. Thank you very much, Mr. Chairman.

Thank you. I thank the panel.

Chairman LEACH. There is nothing wrong with you, Rick.

Mr. JOSLIN. Mr. Chairman.

Chairman LEACH. Yes, Mr. Joslin.

Mr. JOSLIN. Nothing the matter with the math, but we had better define the terms. I think we have thrown some numbers around that may not fit the exact terms, but that is for the committee to work on.

Mr. WEBER. May I just make a point, too, since you have brought me up.

Chairman LEACH. Of course.

Mr. WEBER. You are absolutely right about the math. \$21 billion is the point at which the Federal reinsurance would kick in, nothing below that. So the private market, as you suggest, would take up the rest of that slack and the trigger in Florida is \$21 billion under the bill.

Mr. HILL. If I might interject, Mr. Chairman, my point is that the concern here with availability of insurance in Florida is the \$14 billion in the primary market; and that is where we have the problem, and that is where we have the problem with redundant claims where we have multiple catastrophes occurring in a single year which argues for the case that I make that we ought to find a way to strengthen the opportunity for primary insurance companies by providing a mechanism for them to prefund catastrophic claims.

I thank you again, Mr. Chairman.

Chairman LEACH. Well, I thank you, Mr. Hill. I know of no bill that has more pros and cons than this one, and no bill that is more appropriate for people of contrasting perspectives to present their views.

Is there anyone on this panel that would like to conclude with any observation that you think has not been fully dealt with at this point?

Mr. JOSLIN. The hour is late. We thank you very much for your indulgence on a Friday afternoon.

Chairman LEACH. Thank you, and let me apologize to you and others at the awkwardness of moving a hearing, based upon the death of a Member, and then having intervening circumstances on Friday as well.

So let me thank the panel, and we appreciate your testimony.

The next panel will be composed of Mr. Robert W. Pike, who is Executive Vice President for Administration of the Allstate Insurance Company of Northbrook, Illinois; Mr. Darryl D. Hansen, who is Chairman and President and CEO of GuideOne Insurance Group, West Des Moines, Iowa, on behalf of the National Association of Independent Insurers; Mr. Tom Miller, who is Director of Economic Policy Studies, Competitive Enterprise Institute; Ms. Barbara Connery, who is a member of the North Carolina Association of Realtors on behalf of the National Association of Realtors; and Mr. Scott A. Gilliam, who is Assistant Secretary, Director of Government Relations of the Cincinnati Insurance Companies.

I might note that I have been notified that Mr. Pike has a connection that he would like to keep.

Mr. PIKE. Thank you very much, Mr. Chairman.

Chairman LEACH. Thank you, Mr. Pike.

By unanimous consent, all of your full statements will be placed in the record and you may proceed as you see fit.

**STATEMENT OF ROBERT W. PIKE, EXECUTIVE VICE PRESIDENT, ADMINISTRATION, ALLSTATE INSURANCE COMPANY**

Mr. PIKE. Thank you, sir. I will refrain from reading my testimony. Certainly Mr. Joslin, Mr. Hanna and Mr. Weber more than covered the points, and far better than I could, in their testimony on the second panel.

I think, if I can be of any value to the committee, it would be to touch on the one issue that Mr. Nutter indicated that in his mind was the most important, and that was the existing capacity within the insurance industry to take care of these catastrophic losses. I would suggest that the issue of capacity is nothing more than the sum total of the capacity that exists within the primary market, companies like Allstate and State Farm, the capital that exists within the reinsurance market, and arguably the implicit capacity that might be contained in the California cat fund and the Florida hurricane fund.

That capacity is an interesting issue, because as Frank Nutter very properly indicated, at this time that capacity seems to be sufficient. Allstate Insurance Company happens to be the largest purchaser of catastrophic reinsurance. Nobody buys more than we do, so I think we have a reasonably good handle on how much really

exists. We cannot buy enough. We certainly cannot buy enough at prices that could ever be forwarded onto the backs of the bill-paying customer. But when we talk about capacity, we have to realize that it is a time and place that we are talking about. The reason we have capacity in the insurance industry now is quite simply the fact that the asset valuation of our industry has never been greater in the last five years. The S&P has gone up approximately 27 percent a year. The long bonds are around 7.8 percent. In addition to that, we have had five years of unprecedented and arguably atypical catastrophe experience. So we have actually had five years of the "best of times," to take a page out of Dickens.

What we have not had, of course, is the "worst of times," and as soon as interest rates spike and the concurrent equities go down, as so often happens, or as soon as there is this unfortunate catastrophic event, then that insurance capacity that we speak of today which, whether it is imagined, illusionary or real, will clearly disappear.

I think it is important that we realize that insurers, by definition, insure for essentially low-severity, high-frequency events. We know how to deal with issues like that. That is what we insure against.

We are not good, nor can we insure, against the very high-severity, low-frequency event. Hurricane Andrew is a classic example of that for the Allstate Insurance Company. In that case, we gave back in one day all the premiums we acquired, including investment income, from every line of business we wrote in the State of Florida for 60 years.

The private sector isn't capable of absorbing or maintaining that kind of capacity, nor is the reinsurance industry capable of providing that kind of capacity at affordable prices.

H.R. 21 is, very simply, as good a public policy as this committee, after years of deliberation, could surround itself around while still maintaining a viable and workable private marketplace for both primary insurers and reinsurers. We are not talking about taking care of the State Farms, the Allstates, the Farmers, or the Independent Agents every time an event happens. We truly are talking about the 1-in-100-year event, which is simply not a mechanism that can be handled alone by the private sector. But a joint cooperative without subsidy, with the Federal Government supporting it as Secretary Eizenstat has indicated, is a solution; and it is a solution, Mr. Chairman, that I commend you and your leadership for endorsing and supporting. Thank you.

Now have to catch a plane, Mr. Chairman.

Mr. Chairman: Fair enough.

Mr. Chairman: I do apologize.

Mr. Chairman: Fair enough. Could I ask just one 30-second question?

Mr. Chairman: Please.

Mr. Chairman: Isn't there a second definition to capacity, that is, the assessment of capacity, that is, you line up all of the wherewithal that exists but coupled with that has to be the willingness of a company to risk that wherewithal and that forms a second definition of capacity?

Mr. PIKE. Absolutely. Our equity, our surplus, doesn't just support the 6.5 million homeowners. It supports all of the automobiles which we insure, and we have to allocate that. So your comment and your point is exactly correct.

Chairman LEACH. I am not sure you gathered exactly what I was getting at, that you may be a company with great capacity, but you also may be unwilling to take on the risk of a given line of insurance.

Mr. PIKE. Exactly.

Chairman LEACH. That point means that all of that capacity that is out there doesn't necessarily allocate to this particular problem.

Mr. PIKE. Oh, exactly.

Chairman LEACH. That is the only point I wanted to draw.

Mr. PIKE. You are exactly correct.

Chairman LEACH. That is, of all the dollars that exist in the various insurance company net worths, which fortunately have risen, that does not necessarily mean it applies to the risk associated with the calamity, because most of these companies have not taken on that risk and have chosen not to.

Mr. PIKE. That is certainly our experience in the marketplace today.

Chairman LEACH. Thank you.

Mr. PIKE. Thank you, sir. And I do apologize.

[The prepared statement of Robert W. Pike can be found on page 349 in the appendix.]

Chairman LEACH. Thank you.

Mr. Hansen, who is going to apply thoughtful Iowa logic to this dilemma.

#### **STATEMENT OF DARRYL D. HANSEN, CHAIRMAN, PRESIDENT AND CEO, GUIDEONE INSURANCE GROUP, ON BEHALF OF THE NATIONAL ASSOCIATION OF INDEPENDENT INSURERS**

Mr. HANSEN. Excellent.

Good morning—or good afternoon, I should say. My name is Darryl Hansen, and I am Chairman, President and CEO of GuideOne Insurance of West Des Moines, Iowa. I am also a member of the Board of Governors of the National Association of Independent Insurers, known as the NAI. Mr. Chairman and Members of the committee, I would like to thank you for inviting me here to comment on H.R. 21.

I wish to state up front that I support the reinsurance proposals contained in H.R. 21, both on behalf of GuideOne Insurance and the NAI.

GuideOne Insurance is a medium-sized company that writes consumer business across the United States, including many areas affected by catastrophic losses. The NAI is comprised of over 600 member companies, many of whom are also small- to medium-sized and write business in the same areas.

As a result, GuideOne and many NAI members are exposed to exactly the type of financial risks that H.R. 21 is intended to alleviate, and we are vitally interested in the outcome of the debate over H.R. 21 for reasons I will describe.

I have submitted written testimony that presents several concepts and points in detail, but during this statement I wish to em-

~~address~~ three points. First, H.R. 21 addresses only catastrophes that are of truly a significant magnitude and which could have a negative financial impact upon the economy and financial markets of the country as a whole.

The catastrophes contemplated by H.R. 21 would not be limited to ~~one~~ geographic area or only to the insurance industry. This is ~~not~~ a situation where people who live in Florida or California would receive subsidies, nor is it a bail-out of the insurance industry. The program contained in H.R. 21 is a high-level reinsurance safety net that will respond only to the worst-case scenarios and will preserve a national economy from serious interference. This bill does benefit the entire country.

The second point I wish to make is that catastrophe reinsurance plays an important role in the operations of many, if not most, insurance companies. It is definitely a critical factor in small- to medium-sized companies, especially those that do business in geographic areas that are prone to catastrophes. Without adequate catastrophe reinsurance, these insurers simply could not operate in these geographic areas. In that event, homeowners' insurance is either unavailable or priced to reflect the full risk and thus virtually unaffordable. Therefore, to the extent that a highly competitive insurance industry depends upon a solvent and reliable reinsurance market, the H.R. 21 proposal will bolster the available resources to the insurance industry, albeit on a high-level safety net basis. This bill will benefit a competitive insurance marketplace.

Third, the ultimate consumers, persons who own or wish to purchase homes, suffer a distinct disadvantage when homeowners' insurance becomes unavailable or unaffordable. Lenders will not lend money for mortgages and builders will not build new homes where insurance is not accessible. When small- to medium-sized insurers elect to avoid the serious risks presented by catastrophe-prone areas, homeowners' insurance becomes inaccessible or available only from a limited number of insurers. In either event, the usually vibrant, competitive insurance market ceases to exist. People are then faced with the choice of relocating their homes or being exposed every day to the total loss of their most important asset, their homes. By reinforcing the reinsurance market with respect to the most serious types of losses, availability and affordability will be enhanced. This bill will benefit consumers.

In summary, the H.R. 21 proposal will insulate the national economy to a great extent from a truly major catastrophic event, will enhance a competitive insurance environment and will benefit consumers. At the same time, H.R. 21 will act as a supplement and not a competitor to the existing private insurance and reinsurance markets.

I urge you to vote in favor of H.R. 21.

Thank you again for inviting me to appear today.

[The prepared statement of Darryl D. Hansen can be found on page 356 in the appendix.]

Chairman LEACH. Thank you, Mr. Hansen.

Mr. Miller.

**STATEMENT OF THOMAS MILLER, DIRECTOR OF ECONOMIC  
POLICY STUDIES, COMPETITIVE ENTERPRISE INSTITUTE**

Mr. MILLER. Thank you, Mr. Chairman. I am Director of Economic Policy Studies at the Competitive Enterprise Institute. We thank you for the opportunity to discuss the Homeowners' Insurance Availability Act. For the last five years, our insurance reform project has urged market-based reform of insurance coverage for catastrophic risks.

Although H.R. 21 represents an improvement over previous versions of Federal reinsurance proposals, it fails to present the best answers to the challenge of dealing with natural disaster risks. The bill still has the potential to undermine private insurance markets and crowd out the development of better alternatives. It remains likely to produce cross-subsidies from low-risk insurance policyholders to high-risk ones, distort incentives for loss control and loss mitigation, further subsidize development in catastrophe-prone areas, increase unnecessary Federal intervention in State regulation of insurance, and impose significant financial risk on taxpayers throughout the country.

Private insurance and financial markets can effectively manage catastrophic risk if supported by sound Government policies. Unfortunately, the pricing provisions of the Homeowners' Insurance Availability Act threaten to distort those private insurance markets. The full effects of those provisions remain uncertain, in part because the Secretary of the Treasury would retain a considerable amount of discretion in setting those prices and implementing the reinsurance program. It is highly doubtful that the Federal Government would perform better than the insurance industry in overcoming the problems of estimating catastrophic losses and properly pricing insurance contracts.

Given likely political pressure by particular States and other interests to keep the reinsurance contract prices low so that insurance coverage would be affordable in high-risk areas, it remains much more likely that the Federal reinsurance contracts will be priced too low rather than too high. The coverage triggers under H.R. 21 remain relatively low compared to current private sector insurance capacity. The level they set for Federal coverage would impede the development of private market insurance coverage.

Private industry has already handled much more costly events, and since Hurricane Andrew and the Northridge earthquake, industry capacity has grown significantly. Reinsurance availability has increased remarkably. Industry capacity and efficiency to handle catastrophic risks continues to improve.

Although gaps in insurance coverage and capacity provide a necessary role for further development of innovative financial instruments and contracts to handle catastrophic losses, those shortfalls in private sector financing do not yet justify a new Federal reinsurance program. Instead of encouraging greater private financing and more market-based approaches, H.R. 21 would invite more intervention by Federal and State governments. The lure of potential Federal reinsurance subsidies would foster the growth of State reinsurance funds in residual market pools, as well as the creation of new ones.

A large degree of regulatory control on rates and the supply of coverage accompanies those mechanisms. Over time, they tend to crowd out viable private sector coverage, in part due to their favorable tax status. Price and supply controls also tend to produce cross-subsidies, which in turn inefficiently distort incentives for loss control and loss mitigation.

If enacted into law, a Federal reinsurance program would be likely to live on indefinitely, as all but a few Federal programs do, despite the sunset dates provided in H.R. 21. The combination of regulatory discretion and political pressures in future years make adherence to actuarial principles in market-based pricing for Federal reinsurance unlikely, thereby increasing potential unfunded liabilities that can be transferred to Federal taxpayers.

The current Federal reinsurance proposal does not address the underlying regulatory and tax policies that have limited the availability of insurance coverage that can be offered to consumers and underwritten by private insurers of catastrophic risks. As the Shadow Insurance Regulation Committee concluded last March, constraints on insurers' efforts to charge adequate rates decrease the voluntary supply of catastrophe insurance and hamper insurers' ability to purchase reinsurance and other financial instruments to diversify their catastrophe risk. Restrictions on rates and underwriting also discourage the entry of new insurers into the market that could enhance the availability of coverage.

Current Federal tax rules make insurance against relatively rare, but very large catastrophe losses much more expensive because insurers are not allowed to establish tax-sheltered reserves for catastrophe losses. They can only deduct losses that have occurred. The combined effects of taxes on premiums and investment income produce very large premiums in relation to expected indemnity for small probability events. A well-designed system of tax-deferred reserves for catastrophe coverage would materially improve the availability and affordability of catastrophe insurance in the private sector. Encouraging growth of substantial prefunded insurer reserves would establish a necessary buffer against insurer insolvencies, keep natural disaster claims handling in efficient private markets and help maintain the link between risk-taking and personal responsibility to risk-based insurance pricing.

Freeing up the private market will, in the long run, prove to be more productive than creating yet another partly disguised Federal subsidy program. Thank you.

[The prepared statement of Thomas Miller can be found on page 362 in the appendix.]

Chairman LEACH. Well, thank you very much, Mr. Miller.  
Ms. Connery.

#### **STATEMENT OF BARBARA CONNERY, DIRECTOR, NORTH CAROLINA ASSOCIATION OF REALTORS, ON BEHALF OF THE NATIONAL ASSOCIATION OF REALTORS**

Ms. CONNERY. Thank you, Mr. Chairman. I appreciate the opportunity today to present the views of the National Association of Realtors on H.R. 21, the Homeowners' Insurance Availability Act. I would like to thank you, Mr. Chairman, as well as Representatives

Lazio and McCollum, for their leadership in building bipartisan support on this very important issue.

I am a realtor from North Carolina and a Director of the North Carolina Association of Realtors. The deterioration in the availability and affordability of homeowners' insurance in disaster-prone areas is an issue of very real concern to NAR. Our members specialize primarily in the business of assisting sellers and buyers in residential sales transactions. It is this business focus that motivates NAR's interest in the resolution of this problem.

Although I am testifying today on behalf of the real estate industry, I cannot emphasize enough that the ultimate victim of the homeowners' insurance crisis is the consumer who is frustrated in his or her attempt to realize the American dream of homeownership. When a young family is precluded from owning a home because homeowners' insurance is too difficult to obtain or too costly to afford, we all suffer the consequences.

Last year, NAR testified before this committee on the difficulties faced by current and prospective homeowners. One year later, the situation has unfortunately not improved. In a number of States throughout the country, including my home State of North Carolina, consumers are burdened by rate increases, as well as reductions in coverage and higher deductibles.

Since homeowners' insurance is difficult to obtain in North Carolina, many homeowners obtain coverage from our State pool, the North Carolina Insurance Underwriting Association. Although such coverage is expensive and limited and was instituted to serve only as an insurer of last resort, it is often the only alternative in many of our communities.

The inability to obtain affordable homeowners' insurance is a serious threat to the residential real estate market. Not only does it imperil the market for single-family detached homes, but for the condominium, co-op and rental markets as well. New home purchases, resale transactions and housing affordabilities are negatively impacted in several important ways. First, homeowners' insurance is a necessary component in securing a mortgage and buying or selling a home. If the potential homeowner is ultimately unable to obtain the required insurance either because it is unavailable or unaffordable, the sale will not be completed. As a result, many creditworthy potential homeowners are priced out of the market.

A recent NAR survey reported that an estimated 2,450 transactions fell through because of difficulties in obtaining disaster insurance; 75 percent, an overwhelming majority of those respondents, cited unaffordability as the reason.

Second, homeowners' insurance is tied directly to the cost of owning a home. If the homeowner is unable to maintain insurance required by the mortgage lender, the mortgage is in default. If insurance coverage is optional, potential buyers may choose not to purchase a home because the insurance is too expensive, or in the very worst case, they may choose to go unprotected.

Third, insurance costs impact rent levels. Insurance costs incurred by landlords are ultimately passed on to the tenants. Consequently, increased insurance costs result in higher rents and a further inability of many renters to enter the homebuyer market.



NAR supports H.R. 21 for the following reasons:

First and foremost, it protects against mega-catastrophes. State programs that have been created to address the problem are well-intentioned first steps. However, neither State disaster programs nor the private insurance industry has the capacity to cover the risks presented by mega-catastrophes far more damaging than either Andrew or the Northridge earthquake. The creation of a Federal disaster reinsurance program today will help to prevent future interruptions in the availability of homeowners' insurance.

Second, it produces fiscal responsibility. By establishing a program which promotes insurance coverage for those at risk of property losses from a natural disaster, H.R. 21 will minimize future unforeseen disaster assistance expenditures. It is far more responsible for the Federal Government to act before disasters occur rather than after.

A strong housing market is the linchpin of a healthy economy, generating jobs, wages, tax revenues and a demand for goods and services. In order to maintain a strong economic climate, we must safeguard the vitality of residential real estate.

We urge the committee to take action this year on this very important issue. Again, Mr. Chairman, thank you for the opportunity to present the views of the National Association of Realtors today.

[The prepared statement of Barbara Connery can be found on page 381 in the appendix.]

Chairman LEACH. Well, thank you, Ms. Connery. We appreciate it.

Mr. Gilliam.

**STATEMENT OF SCOTT A. GILLIAM, ASSISTANT SECRETARY,  
DIRECTOR OF GOVERNMENT RELATIONS, THE CINCINNATI  
INSURANCE COMPANIES**

Mr. GILLIAM. Thank you, Mr. Chairman and the remaining Member of the committee, last but not least. I couldn't resist.

One more personal note. I have something in common with Congressman Lazio, who had to leave to go home to his six-year-old daughter's birthday party. My nine-year-old daughter is anxiously awaiting my arrival for the same purpose, so I will try and be brief.

Mr. Chairman, I am Director of Government Relations for the Cincinnati Insurance Companies, headquartered in Cincinnati, Ohio. Our group of companies market property and casualty insurance in 29 States and are among the top 20 publicly traded property and casualty insurers, based on 1998 revenues of \$2 billion. I am honored to be with you today to present the Cincinnati Insurance Companies' perspective on H.R. 21. We commend you for your leadership in holding this hearing to address the issues of natural disaster exposure and insurance.

You have my written testimony, which I will now briefly summarize. The catastrophe exposure we face from our own book of business has prompted us to engage in this important debate.

Our hurricane exposure in Florida and Alabama alone is nearly \$1.8 billion, representing over 10,000 homes. In the Midwest, our estimated exposure from a 6.8 Richter Scale earthquake in the New Madrid fault region is in excess of \$13.4 billion, which would damage more than 118,000 homes.

These are significant exposures for the Cincinnati Insurance Companies when considered in relation to the current level of assets for our property casualty group, \$6 billion.

Let me turn now to the legislation at hand, H.R. 21. We do not disagree that there may be a need for high-level Federal involvement in excess of private market capacity to insure that Americans are provided with appropriate insurance protection for losses arising from hurricanes, earthquakes and other natural disasters. However, we have several concerns with H.R. 21 as it is presently drafted.

Our primary concern with H.R. 21 is its trigger for payment of losses, a trigger which is far below existing industry capacity. As currently drafted, the trigger for payment of losses is as low as \$2 billion, despite the fact that the industry paid losses from Hurricane Andrew of \$16 billion to \$17 billion and from the Northridge earthquake of \$12 billion.

Why should the Government step in at such low levels at a time when the industry continues to gain financial strength?

Since 1992, the industry's policyholder surpluses increased from \$162 billion to over \$333 billion today.

The fact of the matter is, the industry has handled all catastrophes to date regardless of their size, and it has handled them totally within the private sector. But with trigger levels as low as \$2 billion, H.R. 21 shifts catastrophe risks from the private markets onto the Federal Government. This form of low-level risk transfer runs counter to conservative principles of less Government, less Federal spending and a balanced budget.

These concerns were echoed by Treasury Secretary Larry Summers in January of this year in written remarks he delivered to a forum for property casualty insurers in New York, stating that a Federal reinsurance program like that proposed under H.R. 21 should impose no net cost on the taxpayer and the Federal Government cannot be the billpayer of last resort for such insurance.

However, in the Congressional Budget Office cost estimate of H.R. 219, a Federal reinsurance bill introduced in the last Congress with features identical to H.R. 21, CBO concluded that it may not be possible to establish a price for the contracts that would have no present-value cost to the Federal Government. CBO expressed doubts that Federal reinsurance contracts could be priced so that contract revenues exceed payments and predicted the passage of the predecessor to H.R. 21 would likely result in a net increase in direct spending by the Government, thereby exposing taxpayers to a maximum of \$25 billion annually in mandatory obligations to pay purchasers of insurance contracts. We do not believe that CBO's prediction has been taken seriously.

Another concern is the anti-competitive effect H.R. 21 may have on existing markets. Most insurers act responsibly, avoid large concentrations of risk, and purchase adequate reinsurance or otherwise develop adequate resources to absorb shock losses. Under H.R. 21, these responsible insurers would have to compete against irresponsible carriers who have overconcentrated their risk in catastrophe areas and put themselves in a position of having to rely upon State pools or other Government mechanisms to absorb shock losses.

As one major insurer admitted in a notice to its Florida policyholders after Hurricane Andrew, "In the past, despite well-intentioned efforts to determine what our policyholders should pay for insurance, we greatly underestimated the cost of covering hurricane damages. Over the years, our policy was of providing insurance to everyone who qualified and that we sold our product at too low a cost to too many people. We now know that it is not good business for anyone to insure every third or fourth home in an area where natural disasters strike."

With the low-level Federal backstop of Florida State pools under H.R. 21, such overexposed carriers will likely continue to rely on State pools to absorb shock losses and ignore the peril of risk concentration. Clearly this gives those companies an immediate and unfair market advantage and rewards irresponsible behavior.

Moreover, H.R. 21 would give these carriers further incentive to write insurance in even higher concentrations in high-risk areas, further exposing the Federal Treasury.

H.R. 21 is also flawed in that it does not provide coverage for commercial losses, despite the fact that both personal and commercial lines of insurance coverage are affected by catastrophic events. For example, our company's commercial hurricane exposures in Florida and Alabama are nearly as large as our personal lines exposure. Our personal lines exposure is \$1.7 billion; commercial, \$1.5 billion. We believe that there is simply no logical reason why commercial risks should be excluded under H.R. 21.

Let me try and quickly conclude this.

While we have a number of concerns with H.R. 21 as presently drafted, we see little chance for the bill to gain industry-wide support unless the unreasonably low triggers are addressed. I have outlined a proposal for raising the trigger in my written testimony, and I will simply refer to it by reference, and let me just quickly conclude.

We do not disagree—

Chairman LEACH. Excuse me. What is your trigger?

Mr. GILLIAM. OK. We would propose a trigger formula that was discussed last year in hearings before this committee by the Reinsurance Association. It would be a three-component trigger that was suggested along the lines of a conservative rule of thumb often used by insurers, which is the following:

The first component would be an amount equal to 5 percent of industry surplus, an amount which insurers routinely retain for cat losses in the normal course of business. Under today's surplus of \$333 billion, that would equate to \$16.6 billion.

Chairman LEACH. Excuse me. Before you say that, isn't it true that many of those insurance figures relate to lines of insurance that have nothing to do with this particular subject, I mean, automobile insurance? Or is that a fair correlation?

Mr. GILLIAM. Well, all—for example, my company, we write home, auto, business, life, all of our surpluses considered together. So it is the financial wherewithal of the entire company.

The second component would be another 5 percent of surplus which equals the amount of exposure which insurers routinely transfer to reinsurers or to other risk-bearing mechanisms. That would be another \$16.6 billion based on today's surplus levels.

The third component would be an amount equal to another 2 percent of surplus to allow for the further development of capital market products. That would equate to \$6.7 billion.

Adding those all together, we would come up with a trigger of \$39.9 billion.

We feel this would be an appropriate trigger which would include residential and commercial coverage, and that it is important that this be considered; because by using surplus and percentages, rather than a static number, the trigger adjusts, based on the financial experience of the industry. This method of calculation and the accompanying dynamic trigger level would take into account private insurance capacity and would avoid a major dislocation of private market capacity in favor of Government intrusion into the marketplace.

Concluding, we do not disagree that there may be a need for high-level Federal involvement in excess of private market capacity to ensure that Americans are provided with appropriate insurance protection for losses arising from hurricanes and earthquakes and other natural disasters, but if this committee and this Congress are serious about passing legislation to protect policyholders against the perils of natural catastrophes, the legislation ultimately adopted must not encourage Government subsidization of catastrophic risk or supplant the private market for insurance and reinsurance.

Unfortunately, H.R. 21, as presently drafted, does not satisfy these minimum criteria. Thank you.

[The prepared statement of Scott A. Gilliam can be found on page 386 in the appendix.]

Chairman LEACH. Thank you, and I thank you all for very thoughtful testimony.

Let me just begin quickly with Mr. Gilliam. It is almost as if you are critiquing on both sides of the equation. That is, you don't like the bill and then you want to double the bill because you want to include commercial. Do I have that right?

I mean, no one else here has argued for commercial coverage. You are arguing for commercial coverage.

Mr. GILLIAM. Well, we have a number of concerns with the bill, as I have outlined, but if it came to a situation where the trigger was raised sufficiently my company would be in a position of, I guess I would say, neutral. We wouldn't jump up and down, but we wouldn't go out and defeat the bill. But we think it is very important that commercial risks be included too, because they are just as vulnerable to catastrophes as residential risks.

Chairman LEACH. Well, I just—let me point out, it is not inconsistent, but it is an anomaly that you are arguing to double the expanse of coverage at the same time you are arguing against the bill. It is awkward.

Mr. GILLIAM. That is my legal training. We always say "It is bad," and then we say, "Here is how we can handle it."

Chairman LEACH. Let me turn to Mr. Hansen, because I think this is very interesting. You are an Iowa company, and you are not the largest company. There are several that are quite a bit larger than you.

Mr. HANSEN. This is correct.

Chairman LEACH. Yet you have an interest in this bill. Can you explain how as an Iowa company that this is important to you?

Mr. HANSEN. We may.

Chairman LEACH. And the similarly situated companies, is what I mean.

Mr. HANSEN. Exactly.

Chairman LEACH. By an Iowa company, I mean a Missouri and South Dakota, and not a mega-company.

Mr. HANSEN. And, frankly, I think we reflect what a lot of smaller or medium-sized companies are probably going through.

Although we are domesticated in Iowa and have our headquarters there, we write homeowners' insurance in 27 States in the country; have about 25,000 to 30,000 homeowners that we do business with. These are not large residential beachfront properties, as was testified to earlier, but our average home value is about \$77,000. These are typical rural or Middle America kinds of homes.

The issue on the table is, these customers are located in many of the areas that we are talking about, that might be subjected to these kinds of risks, whether it is earthquake risk or hurricane risk.

A company our size or smaller doesn't have the resources available to it to avail itself of; I do not get called on by the capital markets offering me lots of alternatives to create securitized instruments, if you will, because my portfolio isn't that big. So I have got to work within my own capital base and my own ability to judge the risk that I can afford to take on, and if I take on a thousand homes in Florida at an average of \$70,000 or \$100,000 in value, that is the equivalent of half of my net worth if a major catastrophe hits. And I have got to make judgments about whether I can afford that. And in the end, I can't afford that.

So I am one of those companies that then withdraws or has to price so aggressively on the premium that I am out of the market in the first place. Customers won't buy from me; they will go to other options, if they are available.

So from our standpoint, I need stability of reinsurance markets. And this H.R. 21 bill, which has been debated for months and months, has gone through the compromise process, and so forth, has negotiated the various terms, the trigger mechanisms, with all the interested stakeholder groups; and it meets my personal criteria as CEO of GuideOne, as well as the NAI's criteria, of a worthy bill. I need this kind of protection, this kind of stability in the market, if you will, to allow me even the option to consider making homeowners' insurance available in these markets, and likewise, my associates who run smaller companies. Without it, we are basically out of the market.

Chairman LEACH. Thank you. That is very interesting.

Let me turn to Mr. Miller for a second. One, you comment that this bill will increase the regulation of insurance at the Federal level, but it is a voluntary option for States and companies. I think it would be fairly true to say it increases the role of the Government to the extent that role implies a little bit of regulation, but there is a major voluntary component to this, isn't there?

Mr. MILLER. That is correct, initially. I think our concerns are less with the bill as it is proposed today, but the bill as it would be enacted and implemented several years down the road.

I think this committee has had long experience with other programs which started out promising to be restricted, not open-ended, and not have all of these additional liabilities. We have to understand the inherent political dynamic of injecting the Federal Government, with all of its good intentions, but also its massive wallet, through the taxpayers, in a manner where we may end up with a very different environment several years down the road. In the same way that Deputy Secretary Eizenstat was asking for increased flexibility in the pricing under this, we have got to imagine what the situation will be five or ten years down the road in a different environment, once we have set in motion what is supposed to be a restrained program, and I think we have got a long experience suggesting that.

Chairman LEACH. I think you have a fair warning. In fact, auctioneers like to say that, "fair warning." I think you could pound your gavel on that and it would be a fair statement.

You also point out that we do have capital markets that are developing, and that that is not insignificant, and I agree with that. On the other hand, there is a possibility that by this particular type of approach that we will be growing more capital markets on the private side, that is, that this Federal intervention will be of a nature that will spur capital markets.

Now, would any of you like to comment on that? Do you think that is pie in the sky, or do you think that it is the other way around?

Mr. MILLER. Just to follow up, I would tend to go in the other direction. There has been a tendency for some of the evolution of the capital instruments to be perhaps not stalled, but hovering over it is the entire specter of: Is there going to be a Federal program? What will be the terms of it? And particularly the alliance of some major insurers deciding that that is the better horse to back politically suggests that there is less enthusiasm or potential for a private capital market solution.

I think that private capital is the long-term answer to this in terms of the capital markets, and we are going to see some rapid development.

Chairman LEACH. Let me ask Mr. Hansen, would you agree with that?

Mr. HANSEN. Not necessarily.

Chairman LEACH. Do you think that private participation would spur a greater private interest in larger markets that don't exist before? And I ask you this because it relates to the question I asked Mr. Pike, that it strikes me that there is a little bit of apples-and-oranges to statistics; that is, it is true that insurance companies have major pockets in many ways, but it is also true that many don't choose, like your company, to enter markets because you want stability and you want protection and therefore you are not going to apply the pockets that you have unless there is a certain kind of arrangement which you can have confidence in.

So that relates back to if there is—I mean, in the first instance, it seems like a logical inconsistency that a Federal role can spur

a private market, because a Federal role is preempting, but where there are markets that are unserved, isn't it the case that a Federal role could expand the private market in such a way that a prudential company might be more likely to participate than they would otherwise?

Mr. HANSEN. I think there is a role. What CEOs worry about is managing risk all the time—financial risk, business risk, all sorts of risks like that—and to the extent that certain kinds of risks like we are talking about here in H.R. 21, are dealt with in ways that we can understand how they are being dealt with, that the bill outlines—for instance, in this way, there is now stability rather than instability in an element of risk we had before that was unstable—if the capital markets were, in fact, functioning and able to handle this risk, I think we would have seen many more instruments not only created and talked about, but actually executed in the public markets or capital markets than we have today. And by virtue of the fact that instruments are not showing up in the capital markets, that leads me to believe that, one, that is evidence that, in fact, the capital markets aren't prepared to take on this kind of risk—don't know how to take it on, can't find investors for this kind of risk.

So that would be just one indication, if you will, for me that if we can provide some high-level stability, as H.R. 21 provides, and take some of that risk away. And again it is not a risk that is being subsidized, in my opinion, as the testimony that was given before, it is not being subsidized by the Government; it is a self-funded risk, if you will. Premiums are going into this reinsurance instrument from the industry itself. So it is not ultimately going to be money out of the Treasury, but it provides the stability that would allow other capital market instruments to be created and work around this top-level instrument, if you will.

I could draw the analogy of home mortgage lending. When the Government would support that program, we found a very vibrant secondary market began to be created that funded billions and billions and billions of dollars of home mortgage instruments, if you will, and it flourished through programs like the VA and FHA, and so forth.

Chairman LEACH. Fair enough.

If Mr. Hill would allow me the discretion of one more question?

Mr. HILL. Of course.

Chairman LEACH. There is a question that has been raised, principally by Mr. Gilliam, of what the trigger level should be, and one might argue \$2 billion is too low. Mr. Gilliam has come up with a figure of \$39 billion, which strikes me as two figures not quite in the same ball park; I mean, that these are two very different magnitudes of where one could be.

Would you have a recommendation, Mr. Hansen?

Mr. HANSEN. The trigger issue here is probably going to be one of those political tradeoff kind of discussions. As Mr. Weber testified earlier, there are really three components to the trigger: \$2 billion all the way up to the 1-in-100-year event kind of trigger and then in between whatever States funds might be available to handle the unique State situation.

The compromise, if you will, that has been worked over and drafted as currently in this legislation, I think, is absolutely acceptable and appropriate; and in our opinion, both in the NAI and speaking for my company, works very well.

To the extent that your committee and Congress will have to draw some compromises along the way, some of that might be open for discussion, but I think when we start getting up into things like 250-year events, \$39 billion kinds of trigger calculations, the devil is in the details, and look at the details before quickly going to those higher amounts.

Chairman LEACH. Well, I appreciate that.

All I must say is that now and again the associations bring in people from my State, and I am always astonished what quality people they bring.

Mr. Hill.

Mr. HILL. Mr. Chairman, it is a mystery why people would bring folks from Iowa to come and testify before your committee, I am sure.

Mr. Hansen, do you buy reinsurance in the private marketplace?

Mr. HANSEN. Yes, we do.

Mr. HILL. Have you been unable to buy as much reinsurance as you would want to buy?

Mr. HANSEN. We buy as much as we believe our risk requires. So we measure up our total risk in our portfolio and go out into the private markets and try and buy as much as possible to cover the risk we have on our book and something that allows me to sleep a little better on the weekends.

Mr. HILL. I understand that, having bought reinsurance for an insurance company. But my question really is, have you been unable to buy reinsurance?

Mr. HANSEN. No.

Mr. HILL. OK.

Mr. HANSEN. In the three years I have been CEO of this company, I have not had that experience.

Mr. HILL. So the marketplace, as it exists today, has been able to accommodate your need?

Mr. HANSEN. Yes, accommodate my needs with our company's current risk profile.

Mr. HILL. Have you sought to buy reinsurance in disaster-prone areas that you have had an interest in entering the market?

Mr. HANSEN. Yes, we have, for—both on the commercial side and residential side. We have found it difficult and could not—we could not factor in the pricing, if you will, in a way that we thought would be competitive.

Mr. HILL. So you couldn't recover the price of the reinsurance and offer the product?

Mr. HANSEN. More difficult for certain kinds of coverage, yes.

Mr. HILL. This issue with regard to triggers I find a most interesting issue, because in the debate we had today there are some people that believe that H.R. 21 has a \$7 billion trigger for Florida; some believe it has a \$14 billion trigger for Florida; and Mr. Weber testified that it has a \$21 billion trigger for Florida. That tells me that the bill isn't particularly concise with respect to defining a trigger.



Would you agree with that, Mr. Hansen? Which trigger do you believe is the correct trigger?

Mr. HANSEN. I don't know.

Mr. HILL. Mr. Gilliam.

Mr. GILLIAM. Well, I have another number. The latest figures from the Florida hurricane cat fund say a 1-in-100-year event in Florida is \$19 billion.

Mr. HILL. OK. Good. Now we have four.

All that says to me is that we need to look at that. But what I do see is Mr. Weber saying it is \$21 billion, believing that that is an appropriate number. You say \$19 billion. Maybe, in fact, we can actually write a bill that would define it at a level—I would be more willing to support a bill that I thought was at a \$20 billion level than a \$7 billion level. That is one of the concerns that I have.

The Chairman made a point, I think the most significant point of this whole debate.

Ms. Connery, you are here saying you need more insurance so people can insure their homes, and I agree with that. The question is, what do we do to get insurance companies to allocate their capacity to risk? That is what the question here is about.

There is \$75 billion, maybe \$100 billion, worth of surplus capacity in the insurance industry, and people aren't willing to put it to this purpose. And the reason for that, I think, is that the idea that I think Mr.—the gentleman, Mr. Pike, from Allstate said the insurance industry seems not to be able to price low-frequency, high-severity risks.

But I remember hearing this debate twenty years ago in liability insurance, too, where people said, "Well, we can't write professional liability and we can't write product liability and we can't write general liability and we can't write environmental liability, because these are risks that occur rarely and they are very severe." But we worked around that by creating financing mechanisms incurred but not reporting loss reserves, which is, in essence, prefunding of claims.

Mr. Gilliam, I would ask you to comment, and maybe you, Mr. Hansen. Since two-thirds to three-fourths of catastrophic losses are paid by primary insurance, isn't part of the solution creating a mechanism for the primary insurance companies to set aside reserves today to pay future claims on property claims as we allow them to do on liability claims?

I would ask you—Mr. Gilliam first, and then Mr. Hansen and Mr. Miller and Ms. Connery—if you would each answer that.

Mr. GILLIAM. My company would agree with that, and we would put it in what we call the mosaic of solutions. There are a number of things that need to be addressed to solve this problem: mitigation and the idea or concept that you put forth of allowing property and casualty insurance companies to put aside on a tax-deferred basis their own reserves to be held for future mega-catastrophes.

Right now we are not allowed to put aside the portion of premium you pay for a cat risk right now and hold it for that future event. The tax laws and the accounting laws don't allow us to do that. We would favor a proposal that would allow us to do that.

But let me also add that—and, again, Mr. Chairman, you questioned me on, you know, bashing the bill and then saying, "But if

you do this, it is OK," and we all know that Washington is a town of compromise; but in some respects, we view the concept embodied in H.R. 21 as kind of a Band-Aid. And the proposal Mr. Hill is talking about, of allowing us to put aside reserves for the future as a cure, there is a short-term problem and there may be elements of H.R. 21 that could address that; but we think it is important that this cat reserve idea be looked at very closely and given good attention by Congress.

Mr. HANSEN. H.R. 21 is on the table today and it has gone through an elaborate process of evaluation and negotiation to get where it is today. The notion of prefunding is a good notion. The notion of setting up a mechanism by which we can anticipate the future in some way has merit, in my opinion. It is another in an array of instruments, if you will, that a company can use to deal with the issue.

Then again, I go back to the notion of, if it is taking this long for H.R. 21 to get to the table, if H.R. 21 were put to the side in order to now debate a prefunding concept—we are now into a one-year, two-year, three-year kind of debate process, and then nothing has moved forward—I would argue since H.R. 21 is as close as it is, let's move forward with that, but not then not address a prefunding concept that may come on the heels. It is part of how the private markets can respond to this issue in the longer term.

Mr. MILLER. We believe that tax-deferred cat reserves are an essential first step before enacting an H.R. 21-type of approach, and we need to strengthen the capacity of the primary market first.

Our tax policies have made it much more difficult to do that in a proper way, and it is essential that we address that as soon as we can.

Ms. CONNERY. I think that the Association of Realtors feels that, first and foremost, we need a solution that makes insurance both affordable and available to homeowners in catastrophe-prone areas. While prefunding certainly is something that we should look at, we are very concerned that this approach might not as effectively promote the availability and affordability of insurance, and I would certainly echo what Mr. Hansen just said.

It has taken H.R. 21 a couple of years anyway to get as far as it has gone, and if we start from scratch, we are now probably a minimum of two or three years out before we come to this point again; and I am not sure, at the rate that companies are still pulling out of the coastal area of North Carolina right now—we have three companies out of 200 licensed in our State that will even talk to us about writing homeowners' policies, and these are limited policies; they are not full homeowners' policies—I don't know that we have got, in many areas of the country, three more years that we can wait without a real serious housing crisis occurring.

Mr. HILL. Mr. Chairman, if you will indulge me for one last question.

Chairman LEACH. Go ahead.

Mr. HILL. One of my concerns is that H.R. 21 is a mechanism that will encourage the creating of more State funds and more State pools which are often perceived as short term solutions to the circumstance which you describe, Ms. Connery.

We have heard testimony from Mississippi, Louisiana and we have earlier testimony from your State. What usually happens with State funds is it drives out the private companies and the private marketplace which usually requires Government bailouts and it almost always avoids effective mitigation. Frankly, one of the effective mitigations may be that you don't build houses in all of the places that you do today.

What I see H.R. 21 principally doing is an opportunity for a handful of insurance companies to transfer their risks to the U.S. Treasury, which is what has occurred in the Florida pool and the California Earthquake Authority. There has been a transfer of risk from the private sector to the public sector.

I would ask you, Mr. Gilliam and Mr. Miller, if you agree with that assessment, and if so what can we do with H.R. 21, working within the context of H.R. 21, to make sure that it doesn't do what I have just described?

Mr. GILLIAM. Congressman Hill, a thought that we have had, right now there are three State funds in the country, Florida, California and Hawaii has a facility. A thought that we have had, why don't we limit H.R. 21 to existing State funds, that way it will not encourage the creation of more State subsidies for insurance and allow other solutions to this problem to have time to bubble up and go through this same process.

Mr. HILL. Mr. Miller.

Mr. MILLER. Within the limits that you have set that is difficult as the bill is designed to help out the State funds.

I would note that we play by two different sets of rules with private insurers as opposed to the State funds. The State funds have the tax advantages that we have talked about that the private insurers need. They also get to cap their exposure. Whereas the private insurers are worried about going insolvent and bankrupt, the State funds will limit their risk. They will have much more restrictive coverage in some cases than private insurers have. So we don't necessarily have them competing on the same scale. That is part of the problem in getting more private insurance capacity into some of these areas, in addition to the rate effects that occur from the subsidization.

Mr. HILL. It is an important point that you make, that the California fund and the Florida fund and the cap reserve created by this would all allow for prefunding of the losses and so it would be in essence saying we would advantage the private sector over the public sector. We can't do it for the private sector, but we can do it for the public sector. That is one of the objections that I have.

Thank you, Mr. Chairman, and I thank the panel. It has been very enlightening.

Chairman LEACH. Thank you. I appreciate the variety of the panel and the observations. I would only stress that I think Rick has a legislative approach that is extraordinarily credible, but it is not precisely a substitute. It could be a substitute, or it could be an add-on to a program like H.R. 21. But obviously from this committee's jurisdiction it doesn't fit. We don't control taxes. But beyond that, we have had the United States Treasury testify today that they would object to it, and so that means even if you had a couple of years, you have a probable veto. It also means that one

aspect of the Treasury that is a little different than some Government departments, the Treasury is the Treasury of a nature that is kind of true of all administrations. That is that when you switch political parties, you don't suddenly have a different Treasury position. It takes a lot to move Treasury.

So as much as this might be a good alternative or a better alternative, I am not sure that it is a credible alternative at this time, and certainly for the next couple of years.

Mr. HILL. Would the Chairman yield on that point?

Chairman LEACH. Of course.

Mr. HILL. I think the Deputy Secretary did leave open the door to a discussion; and ironically it could be that H.R. 10 will generate the revenue source that could be used to offset the tax offsets that would be necessary to fund deferred tax reserves, so it may be more feasible than we think.

Chairman LEACH. We can be hopeful, but I am not sure that is exactly what I heard from the Deputy Secretary. In any regard, we can all go back and look precisely at what he said. That leaves us with H.R. 21.

I will only say that we will take together all of the comments that have been made today and I will review the testimonies that I wasn't here to listen to. We will then talk to all of the Members of the committee and see if there is a consensus to move in, recognizing that an issue like this will never get unanimity, and we will see where we are come the end of the August break.

In the meantime, I am going to ask staff to review with Treasury where they are, review ideas suggested today, and we will see if we can get a basis for a bill that might credibly be received by the full House.

I want to thank you all very much and indicate a particular appreciation of those of you who came from long distances. The hearing is adjourned.

[Whereupon, at 3:25 p.m., the hearing was adjourned.]



# **APPENDIX**

**July 30, 1999**



# CURRENCY

Committee on Banking  
and Financial Services

James A. Leach, Chairman

For Immediate Release:  
Friday, June 30, 1999

Contact: David Runkel or  
Andrew Parmentier (202) 226-0471

**Opening Statement  
Of Rep. James A. Leach  
Chairman of House Banking and Financial Services Committee  
Hearing on H.R. 21, Homeowners' Insurance Availability Act**

On behalf of the Committee, let me extend a warm welcome to Deputy Secretary Eizenstat and our distinguished panel of private witnesses. The Committee meets today to receive testimony on H.R. 21, the "Homeowners' Insurance Availability Act of 1999," introduced by Housing Subcommittee Chairman Lazio and Committee Vice Chairman McCollum and sponsored by 20 members of the committee.

We will be recessing today's hearing at 11 am for an hour, so members can attend the memorial service for our former colleague George Brown in the Capitol. Because we have limited time it is my hope we can keep opening remarks brief.

H.R. 21 addresses the threat of natural disasters to the availability of adequate and affordable homeowners insurance. It is similar to legislation passed by the Committee in the 105<sup>th</sup> Congress with bipartisan support.

The Committee will hear from a broad spectrum of witnesses, who have been asked to address philosophical, as well as practical, questions regarding the nature and role of the federal government in this issue. The committee has worked with the Administration in every step of the legislation's development, and I am especially looking forward to the comments from Deputy Secretary Eizenstat.

It is my hope that legislation can be advanced which will represent real opportunity for families to protect their homes, while at the same time avoiding significant contingent liabilities by the federal government. In this regard, it is my intention to remain open-minded in the pursuit of a consensus which satisfies these priorities. Based on our hearing today, I would hope to be in a position to consider bringing legislation to the House floor early this fall.

The distinguished ranking Member is recognized for an opening statement.

#####



## Florida House of Representatives

John Thrasher, Speaker

### Committee on Insurance

Consumer Affairs Council

**Stan Bainter**  
Chair

**Leslie Waters**  
Vice Chair

July 23, 1999

The Honorable James A. Leach, Chair  
Committee on Banking and Financial Services  
United States House of Representatives  
B-303 Rayburn House Office Building  
Washington, DC 20515-6050

Dear Chairman Leach:

Thank you very much for inviting me to testify before the House Committee on Banking and Financial Services on H.R. 21, the "Homeowners' Insurance Availability Act of 1999" on Tuesday, July 27, 1999. Unfortunately, I will be unable to participate due to scheduling conflicts.

As you know, I testified before your committee in August 1997 on behalf of the National Conference of Insurance Legislators (NCOIL) in support of a bill identical to H.R. 21. That testimony is relevant and applicable to H.R. 21. Just last week, I shared my thoughts with Subcommittee Chairman Rick Lazio and updated my previous testimony in a letter dated July 12, 1997.

Since I am unable to attend your hearing, I am enclosing a copy of my 1997 statement and my recent letter to Congressman Lazio. If possible, I would like to have these materials made a part of the record or at least considered in the course of your deliberations.

Mr. Chairman, H.R. 21 is an important piece of legislation that I hope Congress can finally enact. If there is anything I can do to assist you in this effort, please do not hesitate to let me know.

Sincerely,

*Stan Bainter*  
Stan Bainter  
Representative, District 25

Enclosures

SB/sth

402 South Monroe Street Room 406, House Office Building Tallahassee, Florida 32309-1300 (850) 414-7365



STATEMENT OF  
FLORIDA STATE REP. STAN BAINIER,  
IMMEDIATE PAST PRESIDENT OF  
THE NATIONAL CONFERENCE OF INSURANCE LEGISLATORS (NCOIL)  
AND VICE CHAIR OF  
THE NCOIL SELECT COMMITTEE ON NATURAL DISASTER INSURANCE,  
PREPARED FOR DELIVERY AT A FIELD HEARING ON  
"NATIONAL POLICY APPROACHES TO THE LACK OF  
AVAILABLE HOMEOWNERS' INSURANCE IN DISASTER-PRONE AREAS"  
HELD BY THE U.S. HOUSE OF REPRESENTATIVES  
SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPORTUNITY  
AT THE NATIONAL HURRICANE CENTER,  
FLORIDA INTERNATIONAL UNIVERSITY,  
MIAMI, FLORIDA  
AUGUST 25, 1997

Chairman Lazio, members of the Subcommittee, my name is Representative Stan Bainter.

It is my privilege to represent 120,000 residents of the 25th House District in the Florida House of the Representatives.

It is also my privilege to be the immediate past president of the National Conference of Insurance Legislators (NCOIL). I now serve as Vice Chair of NCOIL's Select Committee on Natural Disaster Insurance. Also serving with me on the Select Committee are Representatives John Cosgrove of Miami, Chair of the Select Committee, and Steven Geller of Pembroke Pines.

At 5:30 a.m. on that Monday morning five years and one day ago, Representative Cosgrove's home lay at ground zero, and Representative Geller's was not that far away. And I knew that even though I live more than 200 miles from landfall, my home was at risk, too.

What we did not know at the time was that Hurricane Andrew would devastate the homeowners' insurance market in Florida, making basic required homeowners' coverage much more expensive and much harder to get everywhere in Florida. Representatives Cosgrove, Geller and I, although we represent different areas of Florida, could all tell you about the premium increases we have had to pay, our difficulties in obtaining property insurance, and the countless constituents who have appealed to us to help them out of this mess. So could any other member of the Florida Legislature, or any member of Florida's Congressional Delegation.

I have lived in Florida—both South Florida and Central Florida—for almost 40 years. In that time we have seen 15 of the 57 hurricanes that hit Florida in this century, but only two of the six Category 4 storms: Donna in 1960 and Andrew five years ago. We had no idea that Andrew would be so devastating. Neither did the insurance companies. And the attempts to adjust to the new realities of our hurricane potential have not been smooth. Today, the voluntary, private sector homeowners' insurance market does not work well anywhere in Florida, and does not work at all in some parts of Florida.

Recently, scientists from the Hurricane Research Division of the National Oceanic and Atmospheric Administration and from the National Center for Atmospheric Research calculated the costs of some historic hurricanes as if they had happened today. The result: 10 hurricanes since 1925 would have caused losses of more than \$5 billion each if they hit Florida today. The worst, the 1926 Category 4 storm that wiped out Miami Beach, would today cost over \$72 billion. It's the prospect of more Andrew-sized hurricanes—and worse—in the foreseeable future that has created a need for insurance capacity that appears to be beyond the ability of the private sector or state governments to meet.

We know what the problem is

We know what's needed to respond to the problem.

We know that in Florida we have begun to respond in a substantial way.

We know that some other states have made progress.

We know we need to do much more.

And we are beginning to understand that a good part of our problem lies in getting people to understand that our problem is also their problem.

We need to communicate. We need to make our fellow legislators in the states and in Congress aware of the fact that they are chipping in big time for the likes of Andrew and the likes of Northridge.

Your Committee needs to have these types of hearings across the country. You could have them in places that don't consider themselves disaster prone. And you could have them in places that only recently have come to consider themselves disaster prone, like Grand Forks, North Dakota.

And most important, you could have them in places that do consider themselves disaster prone.

We need to combine our somewhat far-flung constituencies. What's needed is a coalition of Members of Congress from coastal states.

Add up those Congressional delegations and you have a majority of the House of Representatives. And you have more than a third of the Senate for starters, once you include Missouri, Kentucky and the other states on the New Madrid Fault.

And there are even more states if you take in the flood risk, considering the general dissatisfaction with the federal flood program.

I know those state legislators active in NCOIL would be more than happy to work with you in this effort.

The idea that the problem crosses state lines has begun to come across in the states. And I believe the same thing can happen in Congress.

I believe that we can find converts in Congress who will drop the quiet opposition to natural disaster legislation, once we show them it will help their constituents -- and once we show them we have the votes.

# # #

[The above referenced NCOIL resolution is attached.]



## Florida House of Representatives

John Thrasher, Speaker

### Committee on Insurance

Consumer Affairs Council

**Sean Bainter**  
Chair

**Leslie Waters**  
Vice Chair

July 12, 1999

The Honorable Rick Lazio, Chair  
Subcommittee on Housing & Community Opportunity  
Committee On Banking And Financial Services  
United States House of Representatives  
2129 Rayburn House Office Building  
Washington, D.C. 20515-6050

Dear Congressman Lazio:

Thank you for allowing me the opportunity to provide comments on homeowners' insurance to the Subcommittee on Housing and Community Opportunity. As you know, I had the pleasure of testifying previously before the Subcommittee on Housing and Community Opportunity. Unfortunately, I will be unable to attend the hearing in Tampa, Florida on July 12, but I wanted to submit comments with this letter.

I appreciate your efforts and those of Congressman McCollum in drafting this national disaster legislation. The federal government does have a role to play in preparing for major natural disasters as a partner with states. I want to emphasize the primary role states must play. States should do their share to assure that risks are covered for all but the most devastating catastrophic events. Florida has stepped up to the plate and met its obligations. Let me describe to you what we have done.

As you know, Hurricane Andrew drastically changed the face of the property insurance market in Florida. Homeowners' insurance coverage became more expensive and much harder to purchase. Attempts to adjust to the new realities of the Florida property insurance market have not been smooth, but after almost seven years, the market in most areas of our state is recovering.

After Hurricane Andrew, the Legislature created the Florida Hurricane Catastrophe Fund (Cat Fund) to improve the availability and affordability of property insurance in Florida by providing

402 South Monroe Street Room 406, House Office Building Tallahassee, Florida 32399-1300 (850) 414-7365

a form of relatively inexpensive reinsurance to Florida personal and commercial residential insurers. Participation in the Cat Fund is mandatory for all admitted insurers writing property insurance in the state. Legislation passed during the 1999 session capped the claims-paying capacity of the Cat Fund at \$11 billion and granted additional assessment authority to the Cat Fund in order to provide coverage to insurers for more than a single hurricane season.

In December 1992, the Florida Property & Casualty Joint Underwriting Association (FRPCJUA) was created as the state's "insurer of last resort." Those property owners who found themselves unable to procure property insurance from the admitted voluntary market could turn to the FRPCJUA. In an effort to stall the growth of the FRPCJUA, the Legislature took action to prohibit the rates of the FRPCJUA from being competitive with those of the voluntary market. The FRPCJUA also embarked on a legislatively-mandated depopulation effort that included financial incentives for admitted insurers that agreed to take policies out of the FRPCJUA. While the current policy count of the FRPCJUA has dwindled to just over 100,000 with exposures of around \$17 billion, the concentration of policies remains in vulnerable southeast Florida.

While the policy count of FRPCJUA has been falling, the policy count of the Florida Windstorm Underwriting Association (FWUA) has been increasing steadily. The FWUA provides only windstorm insurance for those unable to procure it in the private market. The current policy count is over 490,000 representing \$89 billion in exposure. As in the FRPCJUA, the policies in the FWUA are concentrated in the high-risk area of the state: southeast Florida.

While Florida's property insurance market is improving, a major storm could reverse the progress we have made since the devastation of Hurricane Andrew. A major catastrophic event could potentially deplete the resources of state and private-sector insurers, leading to consumer disruption and availability problems similar to those experienced after Hurricane Andrew. In addition, large assessments would be levied on consumers in order to pay for the losses experienced by the Cat Fund, the FRPCJUA, and the FWUA. The private market and the state could not shoulder the burden of a mega-storm alone. While another major catastrophic event would have serious economic repercussions for Florida, the economic dislocation caused by such an event also would be felt in other states. The economic hardship caused by another catastrophic event in Florida would certainly reduce the overall capacity of insurers to cover risks in other states across our country. The ensuing availability problem in turn would likely produce higher rates nationwide. Federal legislation designed to increase overall capacity, to reinsure events that exceed the capacity of private insurance and state programs, would help all states cope with the effects of a major Florida storm.

H.R. 21 would offer an additional funding source to pay over and above what the state and private insurers are able to pay in the event of a catastrophic storm causing billions of dollars in losses. While the Cat Fund and private insurers together would be responsible for approximately the first \$17 billion in losses here in Florida, federal legislation could provide an additional layer of resources that would be available when the resources of both the Cat Fund and private insurers are depleted. Spreading the burden of such huge catastrophic losses caused by an event of this magnitude is necessary to avoid potentially severe economic and personal dislocation in our state.

I applaud the Subcommittee for holding this field hearing. The threat of a major event is real, not only in Florida, but in other states, such as California and Hawaii. Without federal legislation that would help Florida in the event of a storm larger than Hurricane Andrew, Florida could be back to square one.

Sincerely,

Stan Bainter  
Representative, District 25

SB/mws

1:CORRESP.99MWS/HR21.SB July 12, 1999 (2:48pm)

**Congressman Spencer Bachus**  
**Hearing on H.R. 21, Homeowners Insurance Availability Act**  
**Opening Statement**

Mr. Chairman, I want to commend you for holding today's hearing on the Homeowners' Insurance Availability Act of 1999. Making sure there is adequate insurance against catastrophic natural disasters is critically important, and I want to commend the sponsor of this bill, Mr. Lazio, for his efforts. As we move forward, there is one issue I am concerned about. I want to make sure that any new federal program of reinsurance created by the Congress strikes an appropriate balance between the public and private sectors. I want to be sure we are using taxpayer dollars as a backstop when catastrophes are beyond the capacity of the private markets, and at the same time being careful not to crowd out or replace those private markets.

I am concerned that as drafted, H.R. 21 may not strike that appropriate balance. Several studies have shown that the capacity of the reinsurance marketplace has grown significantly in recent years, and there appears to be an abundance of reinsurance. In addition, many property and casualty companies are experiencing record-breaking surpluses. Innovations within the capital markets to securitize insurance risk have provided alternatives to traditional reinsurance, and brought significant additional capital to the table. With the growth in capacity, there are signs of declining prices. One expert with the Insurance Information Institute has suggested that "[r]einsurance is cheap and plentiful."

Now, I am very much aware of the need to be fully prepared in the event of a catastrophic hurricane, earthquake or other natural disaster, and I fully support Chairman Lazio's efforts to focus our attention on these matters. I just think that we must be careful before committing billions of dollars of taxpayers money that we are not using that money to replace the private sector. It may be that the level at which federal payments are triggered in this legislation will need to be adjusted to reflect the actual capacity of the private sector, and to make sure that the taxpayers are being called upon only as the insurer of last resort. I know Chairman Lazio is sensitive to this, and I look forward to working with the chairman on this bill to ensure that we preserve and encourage the growth of an innovative and expanding private reinsurance marketplace



OPENING STATEMENT OF REPRESENTATIVE MERRILL COOK  
Hearing on H.R. 21, the "Homeowners' Insurance Availability Act of  
1999"

Thank you, Mr. Chairman. Over the past ten years with the cost of natural disasters approaching \$1 billion a week in America, I know we would all like to think our states and our constituents, are immune to a natural catastrophe causing the loss of a home or a loved one. But, unfortunately that is not the case. My own district, in Utah, lies directly on one of the largest fault lines in the West. In the ill-fated event, such as an earthquake, should occur or be predicted to occur in Utah, this bill would help to ensure the availability of homeowner insurance and provide a foundation for sound financial recovery.

I would like to commend the Committee and our leadership -- Chairman Leach, Housing Subcommittee Chairman Lazio, and Vice Chairman McCollum -- for holding this hearing to address this important problem. I am a co-sponsor of H.R. 21 and I am hopeful this bill will clear the Banking Committee soon and be taken up shortly thereafter in the full

House. We need to ensure that homeowners insurance is available and affordable for all Americans and H.R. 21 will help do that.

Finally, I would like to re-emphasize the strong support H.R. 21 currently enjoys. With a bipartisan group of 97 co-sponsors, this bill has a great amount of momentum. Additionally, several of the real estate groups -- like the National Association of Realtors and the National Association of Home Builders whose members face this and other types of homeowner insurance issues everyday -- support the bill. In fact, I would like to ask unanimous consent that a statement in support of H.R. 21, on behalf of the National Association of Home Builders, be submitted for the record.

That concludes my statement. Thank you, Mr. Chairman.



1201 15th Street, NW  
 Washington, DC 20005  
 (202) 822-6470  
 (800) 368-5242  
 Fax (202) 822-8572

July 30, 1999

**Statement for the Record of the National Association of Home Builders for the House of Representatives' Committee on Banking and Financial Services hearing on H.R. 21, the "Homeowners Insurance Availability Act of 1999"**

The 197,000 members of the National Association of Home Builders (NAHB) appreciate the opportunity to submit for the record our views on H.R. 21, the "Homeowners Insurance Availability Act of 1999." First, we would like to commend the leadership of Housing Subcommittee Chairman Lazio, Chairman Leach, Ranking Member LaFalce, Vice Chairman McCollum, and the efforts of the entire Committee, on this important issue.

NAHB strongly believes this is an important issue for Congress to address. We believe H.R. 21 – by creating a federal "backstop" through reinsurance to eligible state insurance programs in the event of a catastrophic natural disaster – will foster accessible and affordable homeowners insurance for millions of Americans. Property damage from recent hurricanes, floods, and earthquakes has already dramatically increased the cost of homeowners insurance in many states and we believe H.R. 21 would go a long way towards addressing this problem.

H.R. 21 would help do this by establishing a sound fiscal reinsurance program to help mitigate the withdrawal of the private sector in those three hazard-prone states, and perhaps across the country. These states have responded to the unfortunate reaction of insurance companies either discontinuing, or drastically cutting back, homeowners policies by establishing some form of insurance or catastrophic fund. Because part of the destruction caused by Hurricane Andrew was attributed to the lack of effective building code enforcement as well as specific code compliance problems, some in Congress and elsewhere have tried to link insurance coverage to certain building code compliance mandates. NAHB has opposed, and will continue to oppose, any legislation containing onerous provisions which mandate building codes and standards from the federal level without any consideration of the cost or affordability to homeowners and renters.

For this reason, NAHB is pleased H.R. 21, as currently crafted, does not contain a federal mandate relating to state and local building code compliance and adoption provisions for disaster-prone areas. At the same time, H.R. 21 begins to address the very real needs associated with the availability and affordability of homeowners insurance for coverage of certain natural disasters. Therefore, NAHB supports the overall objectives of H.R. 21 and the process for moving the bill forward.

While there are certain aspects of H.R. 21 on which NAHB has no formal position, we do believe the provisions relating to state hazard mitigation plans will also have a direct impact on housing affordability and the building industry. As previously noted, H.R. 21 is silent on mandatory federal building code requirements. In addition, H.R. 21 would leave to the discretion of the pertinent states what type of mitigation programs they should adopt. NAHB agrees that the establishment of state programs without federal intrusion is the preferable approach.

Traditionally, the health and safety of the general populace has been the prerogative of the states with the broad support of the federal government – whether in the form of the Federal Emergency Management Agency or a reinsurance program – in the event of a major natural disaster. This longstanding principle is well founded, as it is important to remember that each community, state, or region is subject to a variety of different perils as well as varying degrees of risk. What might be an effective mitigation strategy in Florida may not be an appropriate or effective strategy in Texas or California.

We also believe that state mitigation programs should not be focused exclusively on new construction, but that national strategies should address existing construction which compromise the vast bulk of the housing stock. Such programs could include more timely emergency preparedness and response programs, public education programs, voluntary programs with insurance premium reduction incentives, enhanced code official certification requirements, and a whole host of other strategies – like perhaps a mitigation tax credit. However, we feel these programs should be left to the states to develop to address the particular nuances of their localities.

Finally, NAHB – like the National Association of Realtors – is always concerned that homeowners insurance should be accessible and affordable. Therefore, we supported the inclusion of a study in H.R. 21's predecessor (H.R. 219 in the 105<sup>th</sup> Congress) evaluating the availability and affordability of homeowners insurance and the extent to which state and private insurers are addressing the problem. We are very pleased H.R. 21 contains provisions calling for a similar study. We also support the inclusion of a representative of a consumer group on the National Commission of Catastrophe Risks and Insurance Loss Costs, and would also like to see a requirement at least one representative is from a nationally recognized real estate group. Thank you for the opportunity to present the views of the housing industry on this very important issue. We stand ready to assist you in seeking a legislative remedy to the enormous problem natural disasters pose to housing consumers across our nation.

# Statement of Congresswoman Sue Kelly

## Full Banking Committee Hearing on H.R. 21, the "Homeowners' Insurance Availability Act of 1999"

Friday, July 30, 1999

Chairman Leach, Ranking Member LaFalce, I want to thank you both for agreeing to hold this hearing on H.R. 21, the "Homeowners' Insurance Availability Act of 1999." H.R. 21 represents a great deal of good work on the part of our Chairman of the Housing Subcommittee, Mr. Lazio, Congressman McCollum, Chairman Leach and the rest of the members of this Committee and especially the staff. I am proud to be an original cosponsor of this legislation and to have had a hand in crafting some of its provisions.

We need to clear the air on one of the more controversial sections of this bill, namely the triggers. Last year Chairman Lazio was good enough to include in this legislation an amendment I authored that stipulates, in two different sections of the bill, that this legislation - quote - does not displace or compete with the private insurance or reinsurance markets or capital markets, as determined by the Secretary. End quote. This language provides a flexible trigger in the bill that can move on an annual basis to reflect changes in market capacity. This is a responsible approach since one of the clear objectives of this legislation is not to, in any way, displace the market or market growth potential. The issue that some are talking about when they mention the "trigger" would be the lowest level at which the trigger could be set, known as the "floor" and it's important that people make the distinctions between these two provisions. The issues of the trigger and the floor seem to get confused in the debate. It's important that we be clear to what we are referring. If anyone has concerns about the effectiveness of this language, please contact me. I stand ready and willing to try and address concerns relating to this important language.

I also am a strong supporter of the language in H.R. 21 that stipulates a 50 - 50 cost share in this federal program. It was with the adoption of these responsible common-sense amendments that I became a strong supporter of this legislation. In addition, since all other states take a back seat to the great state of New York, I thought it fitting at this point to ask unanimous consent to insert a copy of the "Report of the Temporary Panel on Homeowners' Insurance Coverage" that was submitted by the chair of this panel Neil Levin, the New York State Superintendent of Insurance.

This report, written by a broad cross section of the insurance industry in New York, details the current state of the New York State homeowners' insurance market. This will be an invaluable reference to this committee since New York is by far the greatest state in the Union, followed closely by Iowa.

I am very pleased that we have such a distinguished panel of witnesses before us today. I thank you all for taking the time to join us here to share your considerable knowledge with us. I look forward to exploring your thoughts and ideas on this legislation as we move forward.

Thank you Mr. Chairman, and I yield back the balance of my time.

**TEMPORARY PANEL ON HOMEOWNERS'  
INSURANCE COVERAGE**

**A Report to Governor Pataki  
and  
Members of the New York State Legislature**



**February 1, 1999**

**Superintendent of Insurance  
Neil D. Levin  
Chair, Temporary Panel**



**STATE OF NEW YORK  
INSURANCE DEPARTMENT  
25 BEAVER STREET  
NEW YORK, NEW YORK 10004**

**February 1, 1999**

**To Governor George E. Pataki and Members of the New York State Legislature**

**In accordance with Chapter 44 of the Laws of 1998, I hereby submit the "Report of the Temporary Panel on Homeowners' Insurance Coverage."**

**The first meeting of the Panel took place on November 30, 1998. Subcommittees subsequently met and the Panel held full meetings on December 14, 1998, and January 22, 1999. The members are all experienced, knowledgeable insurance professionals. They were assisted by staff from the New York State Insurance Department.**

**I would like to thank the members of the Panel for the time and energy they have devoted to assembling this comprehensive report.**

**Sincerely,**

**Neil D. Levin  
Chair, Temporary Panel**

**<http://www.ins.state.ny.us>**



**TEMPORARY PANEL ON HOMEOWNERS'  
INSURANCE COVERAGE**

**A Report to Governor Pataki  
and  
Members of the New York State Legislature**

**February 1, 1999**

**Superintendent of Insurance  
Neil D. Levin  
Chair, Temporary Panel**

## TABLE OF CONTENTS

Page

**Executive Summary.....**

**Preface (Overview & Insurance Department Initiatives).....**

### **Catastrophe Fund Subcommittee Report.....**

- I. Purpose of the Subcommittee.....
- II. Present Availability of Homeowners' Insurance in NY Coastal Areas.....
- III. Catastrophe Exposure for NY Market.....
- IV. Strength of the Private Market.....
- V. Description of Hurricane Insurance State Mechanisms.....
- VI. Alternative Potential Resources to Fund Catastrophes.....
- VII. The Argument for a Hurricane Catastrophe Fund .....
- VIII. The Argument against a Hurricane Catastrophe Fund.....
- IX. Catastrophe Fund Summary & Recommendations .....

### **Market Dynamics Subcommittee Report.....**

- I. Purpose of the Subcommittee.....
- II. History & Current Status of Hurricane Deductible Programs.....
- III. Areas of Agreement: Deductibles.....
- IV. The Argument for Standardized Deductibles.....
- V. The Argument for Flexible Deductibles.....
- VI. Applied Insurance Research (AIR) Deductible Impact Study.....
- VII. Regulation 159 .....
- VIII. Consumer Education Efforts .....
- IX. Mitigation.....
- X. Capital Markets .....

- A. Homeowners' Insurance Deductible Filings, NYS, (as of 1/31/99).....
- B. Tapping the Capital Markets (article summaries).....
- C. AIR Study: Hurricane Loss Analysis-Homeowners.....
- D. Recent Risk Securitization Activity.....

## Executive Summary

### Catastrophe Fund Subcommittee

- The Catastrophe Fund Subcommittee was formed to evaluate the feasibility of establishing a statewide catastrophe insurance fund.
- The Subcommittee believes that the establishment of such a catastrophe fund in New York State at this time is unwarranted for the following reasons:
  - The availability of homeowners' insurance in coastal communities, with few exceptions, has rebounded as a result of efforts by the New York Insurance Department and the insurance community through both legislative initiatives and regulatory programs.
  - The number of homeowners' insurance policies written by the insurer of last resort - the New York Property Insurance Underwriting Association (NYPIUA) - has leveled off and the number of new policies is declining.
  - The property/casualty insurance industry is better positioned to withstand catastrophic events since Hurricane Andrew in 1992. The industry's surplus has risen from \$193.1 billion in 1994 to \$342.0 billion in 1998.
  - There is an overabundance of capacity in the reinsurance market, which is driving down catastrophe pricing.
  - Additional capacity from the capital markets is growing and expected to expand further. The capital markets' funding of catastrophe exposures has grown from one transaction in 1994 totaling \$85 million to eighteen transactions in 1998 totaling over \$3 billion.
  - Creation of a state catastrophe fund in New York raises public policy concerns, among them:
    - A viable catastrophe fund must be exempt from federal taxation. In order to achieve such an exemption, significant state financing of the fund would be required.
    - Cross-subsidization could occur between low-risk and high-risk areas, and commercial policyholders vs. private homeowners' policyholders.
    - It could impede the development of capital market and other alternative solutions.

### **Market Dynamics Subcommittee**

- The Market Dynamics Subcommittee was formed to analyze (1) the issues of homeowners' deductibles (disclosure and triggers), (2) mitigation efforts to reduce loss, and (3) the current state of capital markets in the funding of catastrophe exposures.
- The Subcommittee unanimously agreed that:
  - Deductibles should be triggered by specific wind speeds and only upon classification/naming of hurricanes.
  - Insurers should offer policyholders an option of lower deductible amounts if significant mitigation efforts are undertaken.
  - Catastrophe modeling should be permitted to support rate and deductible filings.
  - Full and adequate disclosure is vital to the success of the current deductible program.
  - An optional supplemental notice should be sent to policyholders by insurers, reminding them to contact their insurer or agent if questions arise.
  - The public should be educated both prior to and throughout the hurricane season.
  - Further consumer education is needed.
  - Lack of an effective New York State performance-based building code needs to be addressed during the 1999 legislative session.
  - As the number of investors participating in the insurance-related capital market grows, issuers of insurance-related securities benefit by having a new and deeper pool of capital to assume catastrophic risk.
- In addition, some Subcommittee members felt that deductibles should be standard among all insurers in order to avoid consumer confusion.
- Equally strong sentiment was expressed by other Subcommittee members that the current deductible program achieves maximum flexibility and should be maintained. The Insurance Department's present program, they believe, has created much-needed opportunities for insurers to increase market share in coastal areas.

## Preface

This report is submitted pursuant to Chapter 44 of the Laws of 1998, which amends Chapter 42 of the Laws of 1996 by continuing the requirement that a special advisory panel be established to make a report to Governor Pataki and the Legislature on problems affecting the affordability and availability of homeowners' insurance in New York State.

In accordance with the legislative requirements, Superintendent of Insurance Neil D. Levin chaired the Panel. The Superintendent wishes to thank the following individual members of the Panel for their participation and generous contribution of time and effort in helping to accomplish the Panel's mission:

John R. Cashin	Willis Faber North American, Inc.
Marsha Cohen	Reinsurance Association of America
Anthony Granito	McNeil & Co. Insurance & Risk Services
Jeffrey Greenfield	NGL Group, LLC
Howard I. Honig	Honig Insurance Agency, Inc.
John B. Johnson	Johnson & Johnson Agency, Inc.
Shelly H. Kozel	Lezok, Ltd.
Mark Kriss, Esq.	Kriss, Kriss & Brignola (Alliance of American Insurers)
Mary Lanning	ML&G Associates
Philip Lawson	Allstate Insurance Co.
Peter Lefkin	Fireman's Fund Insurance Co.
Nicholas Puleio	U.S. Re Corp.
Daniel Robinson	New York Central Mutual Fire Insurance Co.
Michael Rosenzweig	Rosenzweig Financial Services
James E. Ryman	State Farm Insurance Co.
George D. Yates	Dayton & Osborne
Steven Wietlisbach	Travelers Insurance Co.
Lewis Wilson	Fire Mark Insurance

Within the New York State Insurance Department (the Department), an internal task force was formed to assist and coordinate the Panel's activities. The members of the internal task force, chaired by Stephen Maluk, were First Deputy Superintendent Gregory V. Serio, Mark Presser, Janet Glover, Elise Liebers, Charles Rapacciuolo, Michael Moriarty, Christopher McCarthy, Wayne Cotter, Benita Hirsch, Patricia Mann, Anthony Yoder, Murray Hirschhorn, and Marina Lutchman.

This report was prepared by the Temporary Panel on Homeowners' Insurance Coverage. The Temporary Panel is comprised of members appointed by Governor Pataki and various members of the New York State Legislature. Although this report was prepared as a result of meetings conducted in the New York Insurance Department's offices and this report was published by the

**Department, the report is not an official publication of the New York State Insurance Department. It reflects the findings and opinions of the appointed members of the Temporary Panel, and not those of the Insurance Department.**

The full Panel met in plenary session three times in 1998 and 1999. At the direction of the Superintendent, a Catastrophe Fund Subcommittee and a Market Dynamics Subcommittee were formed. The Catastrophe Fund Subcommittee focused its attention on the availability of homeowners' insurance in coastal areas in order to determine the feasibility of establishing a statewide catastrophe insurance fund. It also examined the potential impact of various hurricane scenarios on New York and the ability of the insurance market to withstand such events. The Market Dynamics Subcommittee evaluated issues surrounding homeowners' deductibles, mitigation as a means of reducing loss, and the emergence of capital markets to fund catastrophe exposures.

Presentations were given to the Panel by Dennis Dee and Michael Esemmer of the New York Property Insurance Underwriting Association (NYPIUA), Andrew Kaiser of Goldman Sachs, Karen Clarke of Applied Insurance Research, and John Cashin of Willis, Faber North American, Inc. Legislative updates were provided by Christopher McCarthy of the New York State Insurance Department and Steve Casscles, Counsel to New York State Senator Guy Velella (R-Bronx/Westchester).

Members of the Panel as well as nonmembers served on the two Subcommittees. Subcommittee members are listed in the body of each Subcommittee report.

## **Overview**

Reports issued by the Panel in 1997 and 1998 provided a historical perspective of the origin and evolution of the homeowners' insurance product. Homeowners' coverage has been a source of comfort to property owners and lenders in the development and maintenance of communities throughout America. A homeowners' insurance policy is a vital instrument of financial security for millions of Americans, as well as a profitable line of business for insurers.

In recent years, however, natural disasters, most notably Hurricanes Hugo, Andrew and Iniki, have prompted insurers to reassess their position in the market. Many insurers have reduced their writings on properties located along New York's coast in order to minimize potential losses from an Andrew-like storm. Other steps have been taken by the industry and New York regulators to expand capacity. They include (1) a Coastal Market Assistance Program that secures coverage for hard-to-place risks; (2) the development of windstorm deductibles (which are applied separately from the traditional all-perils deductibles found in homeowners' policies); (3) the expansion of catastrophe reinsurance, capital markets and other risk-spreading mechanisms; and (4) various initiatives to promote consumer education and loss mitigation.

## Insurance Department Initiatives

*(For more detailed information, see page 26)*

The states have responded to the homeowners' insurance problem in various ways. States such as California and Florida, which are prone to earthquakes and weather-related disasters, were compelled to address these issues in an acute crisis atmosphere. In contrast, New York has been responding to market disruptions due largely to the *anticipation* of a catastrophe that has not yet materialized. Because New York's coastal areas are densely populated and highly developed, the potential losses from such a storm could be significant.

Upon assuming office, Governor Pataki reviewed the situation faced by the State's coastal residents. Recognizing that free market initiatives offer the best opportunity to achieve an effective and lasting solution, Governor Pataki stressed the importance of participation of the voluntary insurance market in a coordinated program of response. The State's efforts to address the problem were renewed and strengthened.

New York's response encompasses a combination of regulatory and legislative initiatives, including:

- The Department established the Coastal Market Assistance Reference Tables, or C-MART, to provide, via a special telephone hotline, the names and phone numbers of insurance companies that had indicated a willingness to insure risks in proximity to the shore.
- The Coastal Market Assistance Program (CMAP) was established, consisting of a voluntary network of insurers and producers to assist homeowners residing in coastal areas in obtaining insurance.
- Special deductibles applicable only to the windstorm peril were approved for some insurers as a means of encouraging them to continue to insure properties along the coast.
- "Wrap-around" policies consisting of property coverage provided by the New York Property Insurance Underwriting Association (NYPIUA) and liability protection by a voluntary insurer were approved.
- Governor Pataki signed into law legislation permitting insurers to file multi-tier rating programs for homeowners' insurance, and to strengthen requirements providing for the minimization of market disruptions when insurers seek to withdraw from the homeowners' insurance market.
- The Department issued Regulation 159, which requires insurers to provide detailed disclosure notices to policyholders regarding windstorm deductibles. The Regulation mandates that insurers begin issuing such notices to insureds with all policies written or renewed on or after January 1, 1999.

- The Insurance Department amended Regulation 57 in 1998 to require insurers to provide premium credits to property owners for the installation of storm shutters in order to prevent or mitigate losses.

The New York Insurance Department continues to encourage the development of innovative approaches for the financing of natural catastrophe insurance exposures. Finding more efficient ways to access the capital markets is an essential component of this endeavor.

As indicated in the 1998 report by the Temporary Panel on Homeowners' Insurance Coverage, the Department's initiatives with respect to capital markets include: facilitating proposals using catastrophe bonds and similar instruments; exploring the use of derivatives to transfer insurance risk; authorizing the Catastrophe Risk Exchange, Inc. as a reinsurance intermediary; proposing legislation that permits the issuance of capital notes; considering legislation to permit special purpose entities to securitize insurance risk; and developing a model for a tax deductible pre-event catastrophe reserve on a national level. Some of these initiatives are, *prima facie*, capital market approaches while others have the potential to be integrated with capital market approaches in the financing of natural catastrophe risk.

Following is a 1999 update on these activities:

**Monitoring Capital Market Activities:** The Department has continued to review, and in most cases has approved specific transactions that facilitated insurers' access to the capital markets through the sale of catastrophe and insurance linked securities by insurers. In addition, New York serves as vice-chair of the NAIC Insurance Securitization Working Group, which has been charged with reviewing the continuing developments in insurance securitization.

**Authorization of Derivatives:** Derivative legislation was enacted into law in 1998 and authorizes the use of a wide range of derivative instruments for the purpose of hedging assets and liabilities by licensed New York insurance companies. Although the primary focus of the law is the use of derivatives to hedge against the fluctuation in value of investments (either due to market risk or foreign currency exposure), certain derivative instruments can be used as part of a hedging program to transfer insurance risk to the capital markets.

**CATEX:** The Catastrophe Risk Exchange, Inc. (CATEX) is licensed as a reinsurance intermediary under New York Insurance Law. Through a highly secure, yet flexible, computer-based trading exchange, CATEX provides a means whereby primary insurers and reinsurers can have access to a wider, more efficient means of distributing their risks.

**Capital Notes:** The New York Insurance Department continues to support legislation authorizing the issuance of capital notes by property/casualty insurers. A capital note is constructed as a debt instrument that is carried as a liability on an insurer's balance



sheet, but which may be added to total adjusted capital for purposes of calculating risk based capital. This legislation did not pass in the 1998 New York legislative session.

**Pre-Event Catastrophe Reserve for Insurers:** The New York Insurance Department along with other state regulators have been involved in developing the design for a tax-deductible pre-event catastrophe reserve for insurers. This proposal will promote the safety and soundness of the insurance industry's balance sheet by enhancing the ability of insurers to fund a major catastrophe.

**Computer Modeling:** The Department recognizes that computer simulation modeling is viewed by many in the industry as a viable supplement to traditional ratemaking methodologies. Through such efforts as the issuance of Circular Letter No. 7, the Department is attempting to be responsive to the industry's needs while balancing the desire to maintain a stable and viable homeowners' market in New York for years to come. The Department issued Circular Letter No. 7 on April 7, 1998, requesting insurers to voluntarily provide any computer modeling information used in the development of their rates. At the time of this writing, insufficient information has been furnished by insurers to determine whether computer modeling is an appropriate component of the ratemaking process.

## CATASTROPHE FUND SUBCOMMITTEE REPORT

### Members of the Catastrophe Fund Subcommittee

<b>Christopher Roe</b>	<b>Fireman's Fund Ins. Co., Chairman</b>
James Arment	State Farm Ins. Cos.
Joseph Calvo	New York Property Insurance Underwriting Association
John Cashin	Willis Faber North American, Inc.
Marsha Cohen	Reinsurance Association of America
Ross Davidson	USAA
Joseph Fedor	US Re Corp.
John Friedman	USAA
Mary Griffin	American Insurance Association
Floyd Holloway	State Farm Ins. Cos.
Mark Kriss	Alliance of American Insurers
Mary Lanning	ML&G Associates
Peter Lefkin	Fireman's Fund Ins. Co.
Elise Liebers	New York Insurance Department
Stephen Maluk	New York Insurance Department
John Milette	Travelers Ins. Co.
Michael Moriarty	New York Insurance Department
David Nadig	Allstate Ins. Co.
Nick Puleio	US Re Corp.
Michael Stinziano	E.W. Blanch/Paragon Reinsurance Risk Mgmt. Services, Inc.
Steven Wietlisbach	Travelers Ins. Co.
Jeffrey Williams	Allstate Ins. Co.
David Unnewehr	American Insurance Association
Debra Vasey	State Farm Ins. Cos.
Anthony Yoder	New York Insurance Department

### I. Purpose of the Subcommittee

The Catastrophe Fund Subcommittee was charged with an "evaluation of the feasibility of establishing a state-wide catastrophe insurance fund." In our analysis, we examined the availability of homeowners' insurance in coastal areas as an indicator that further state action may be needed. We also examined the probabilities of hurricanes striking New York and the ability of the insurance market to withstand such events.

Two states, Florida and Hawaii, have established state hurricane funds and the structure of these funds are summarized. Generally, the Subcommittee focused upon the merits of the Florida reinsurance fund because it appears to be less intrusive on the private insurance market. The Florida fund provides Florida-specific reinsurance for homeowners' insurers, while the Hawaii fund sells hurricane insurance directly to the homeowner. As a result, the Subcommittee primarily reviewed the advantages and disadvantages of a hurricane reinsurance fund.

To provide a full discussion on the catastrophe issue, the Subcommittee also summarized two alternative potential resources to fund natural catastrophes. First, one Panel member presented the merits of permitting insurers to set aside federally tax-exempt catastrophe reserves. Second, another Panel member outlined possible structural changes to the Florida fund in order to maximize its flexibility. The Subcommittee did not take a position on these alternatives.

## II. Present Availability of Homeowners' Insurance in New York Coastal Areas

### A. NYPIUA's Rate of Growth

Periodic concerns raised about coastal property insurance availability in New York tend to obscure the fact that the vast majority of Long Island residents and other New Yorkers living near the coast are able to obtain voluntary market coverage. The New York market remains resilient, despite concerns about hurricane risk. One of the most reliable ways of measuring the market's overall health is to track the experience of the New York Property Insurance Underwriting Association (NYPIUA), an insurer of last resort. NYPIUA provides basic insurance to homeowners and businesses unable to find it in the voluntary market. Excessive and rapid growth of residual insurers like NYPIUA would be an indicator of insurance availability problems.

Following Hurricane Andrew, a watershed event for the property-casualty insurance industry, voluntary writers adjusted their total exposures to catastrophic losses, all along the Atlantic coast, including Long Island. In many cases, the adjustments provided new market opportunities for home insurers with small market shares who wanted to write more insurance, but the trend also resulted in an increase in the number of NYPIUA policies on Long Island through the mid-1990s. However, NYPIUA's market share remains minor and its growth in coastal areas has been relatively small compared to property insurance residual markets in other states.

To put coastal property insurance availability into perspective, the following are the most recent trends in the number of NYPIUA dwelling policies:

- **Suffolk County:** The number of NYPIUA policies increased just 1.5% from 1997 to 1998 in Suffolk County to a total of 11,112. Even more positively, the number of *new* NYPIUA policies *declined 26.0% in 1998 over 1997 levels*. Overall policies increased slightly only because renewals of existing policies were higher than previous retention rates. Overall, these trends indicate that the market is currently stable to improving in Suffolk County, probably the most hurricane-exposed area of the state. At the end of 1998, about 2% of Suffolk residential properties had a NYPIUA policy, or about 2 of every 100. A significant number of these policies were written for second homes near beach end coastal areas most exposed to windstorms, rather than primary residences.

- **Nassau County:** The number of NYPIUA policies in Nassau County rose 1.7% from 1997 to 1998 to a total of 5,422 policies. This represents less than 1% of this huge residential market. Furthermore, the number of *new* NYPIUA policies *declined 35.5% from 1997 to 1998*, from 1,840 to 1,187. Only about 1 of every 100 Nassau households now obtains residential insurance coverage through the NYPIUA.
- For **Queens County**, and other coastal boroughs in New York City, the potential number of risks insured by NYPIUA is influenced both by urban and coastal hurricane risks. Even so, only about 1 of every 100 insured households obtained insurance through the NYPIUA. Queens experienced a 0.6% rise in the number of residential NYPIUA policies from 1997 to 1998, but a substantial *30.2% decline in the number of new policies issued*. On Staten Island, fewer than 1 out of 100 households were insured through the NYPIUA as of November 30, 1998. Brooklyn and the Bronx experienced both an absolute decline in total policies and a decline in new policies from 1997 to 1998.

With both a statewide and a coastal region market share of one percent or less, NYPIUA is functioning as intended, as an insurer of last resort. It also appears to be playing a secondary role in easing the impact of temporary adjustments in the voluntary market. Compared to other coastal states, such as Florida, North Carolina, and South Carolina, the shift to NYPIUA in New York's coastal counties has been minimal. The total number of risks in Nassau and Suffolk Counties did increase steadily from 1993 to 1996, as insurers adjusted to the post-Andrew environment, but growth is now minimal and new applications and policies have actually declined.

A number of states prone to natural disasters have experienced tremendous growth in the share of homes insured through residual market underwriting plans. New York's property insurance market has been much more stable. Even in the two Long Island counties most exposed to severe windstorms, the vast majority of risks continue to be served by the voluntary market. There are a total of 868,142 insured households in Nassau and Suffolk Counties combined. About 16,534 or 1.9% of these households received insurance through NYPIUA as of December 31, 1998. NYPIUA is available for the most hazardous risks near the shoreline or on barrier islands, but there is no crisis in the market for property insurance. Indications are, for 1999, that coastal markets will continue to improve.

#### **B. C-MAP And Other Programs Aiding Availability**

In response to public concerns about insurance availability in the mid-1990s, the Insurance Department authorized a Coastal Market Assistance Program (C-MAP) that involved a commitment by participating insurers to write an additional 5,000 policies in coastal areas over three years for risks that were having a difficult problem finding insurance. C-MAP is also administered by NYPIUA. Commitments by individual insurers

are based on market share. C-MAP participants agree to waive their existing underwriting rules, regarding coastal proximity, in providing C-MAP coverage.

The three-year program that started in March 1996 will be completed shortly and, thus far, demand has been less than anticipated, another indication that the coastal market is steadily improving. It should be noted that insurers have only needed to write about 2,900 out of the 5,000 policies anticipated in the commitment. Approximately 2,500 of these have been written on a voluntary, self-selection basis by participating insurers and only 400 have been written through the "rotation method," where policies are assigned to home insurers on the basis of market share.

NYPIUA has pioneered an innovative program to encourage property owners, located within 1,500 feet of the shore, to undertake upgrades that make homes better able to withstand hurricane-force winds. When applying for insurance under NYPIUA, properties located in high-hazard coastal areas are inspected for wind resistance. The inspection typically results in recommendations for improvements to connections and anchors that will make the home and its accessories, such as stairways, decks and porches, better able to withstand high winds. The property owner must undertake recommended improvements as a condition of retaining windstorm coverage. As they become more knowledgeable about the wind hazard and opportunities for mitigation, some property owners even go beyond minimum recommendations in upgrading their properties. Often these more wind-resistant homes become attractive to private insurers, and a coastal risk is removed from the residual market, NYPIUA. Insurers and state officials are working on additional initiatives to promote mitigation in New York, which over the long run will also help to improve availability.

#### **C. NYPIUA's Catastrophe Program**

NYPIUA has developed a favorable catastrophe program that has targeted the 1-in-100-year event. For such an event, it is estimated that NYPIUA's probable maximum loss is \$144 million. (If NYPIUA could utilize a mandatory 2% hurricane deductible, this number would be reduced.) To handle this exposure, the catastrophe excess of loss reinsurance program provides \$74 million in excess of \$55 million in losses. The cost of the reinsurance protection is \$2 million and became effective July 1, 1998, subject to renewal July 1, 1999. NYPIUA also has \$55 million in adequate cash on hand; \$40 million is members' equity in NYPIUA. For larger events, NYPIUA has the ability to recover prospectively by an increase in future rates for NYPIUA policyholders. Other property residual markets, like the Florida Windstorm Underwriting Association and the South Carolina Windstorm Plan, also purchase private reinsurance.

If a deficit results after a hurricane, NYPIUA's recoupment mechanism uses several layers. First, on or before November 1, NYPIUA must annually estimate its "deficit" from operations for the subsequent year and report that information to the Department of Insurance. Provided its liabilities exceed its assets, NYPIUA may recoup any estimated deficit through the following steps (Section 5405 of New York Insurance Law).

1. NYPIUA will be credited with the income earned from the Property and Casualty Insurance Security Fund (not to exceed \$15 million).
- 2a. After application of the funds provided in step #1, a factor is calculated (not to exceed 1%) by relating the remaining deficit to net direct premiums written for the latest year by the voluntary market in New York for the perils of Fire and Extended Coverage, including the same perils contained in Homeowners' Insurance and Commercial Multiple Peril package policies.
- 2b. NYPIUA would immediately assess member companies for the deficit amount while advising members of the factor (surcharge) to be reflected immediately in their rate filings in New York.
3. Any additional deficit amounts not recovered through steps #1 and #2 may be recovered prospectively by an increase in future rates for NYPIUA policyholders.

#### **EXAMPLE: \$140 MILLION NYPIUA LOSS EVENT**

Funding:	\$15 million	Source: NYPIUA equity (5-year average)
	\$15 million	Source: Step #1 P/C Security Fund
	\$25 million	Source: Step #2 Member Cos.
	\$74 million	Source: Reinsurance Program*
	\$11 million	Source: Step #3 Rate Increase

\*Under the reinsurance program, Step #3 would not be activated until the reinsurance is depleted. Reinsurance limits of \$74 million in excess of \$55 million are targeted at preventing the need for recoupment under Step #3 above.

### **III. Catastrophe Exposure for New York Market**

#### **A. Previous Catastrophic Events**

Natural catastrophes are neither a new nor a distinctly American phenomenon. Ancient civilizations witnessed and recorded floods, volcanic eruptions and devastating "tempests." U.S. history has been punctuated by massive earthquakes (New Madrid in 1811-12, Charleston in 1886, San Francisco in 1906, and Anchorage in 1964) and hurricanes (Galveston in 1900, New York/New England in 1938, Mississippi/Alabama in 1969, South Carolina in 1989, and South Florida in 1935, 1950, 1992). Earthquakes around the "ring of fire" have claimed hundreds of thousands of lives in Europe, Asia, Australia, North America and South America, and typhoons, cyclones and other severe storms throughout the world have left millions homeless. Below is a list of the ten largest insured catastrophes in the United States between 1950 end 1994.

**LARGEST INSURED NATURAL DISASTERS IN THE  
UNITED STATES  
1950-1994**

Rank	Year	Catastrophe	Insured Losses* (in billions)
1	1992	Hurricane Andrew	\$18.4
2	1994	Northridge Earthquake	12.5
3	1950	Northeast Winter Storm	11.8
4	1954	Hurricane Carol	6.8
5	1989	Hurricane Hugo	6.3
6	1954	Hurricane Hazel	5.2
7	1965	Hurricane Betsy	4.6
8	1970	Hurricane Cecilia	3.0
9	1960	Hurricane Donna	2.5
10	1991	California Fires	2.3

\*In 1994 dollars, adjusted for Regional Residential House Price Inflation based on Property Claims Services data adjusted for the change in the value of urban and rural owner-occupied buildings in each state using the U.S. Census of Housing Series HC80-1-A. Chart presented by the Technical Advisors in a Report to the NAIC Catastrophe Reserve Subgroup on Resolution of Issues Regarding the Development of Reserve Design Characteristics.

In 1998, the Property Claim Services reported that U.S. property and casualty insurers paid out an estimated \$10.7 billion in natural catastrophe losses for the year. Of this \$10.7 billion, insured property losses from Minnesota's winter storms accounted for \$1.3 billion, while Hurricane Georges damage in the U.S. reached \$2.95 billion.

#### **B. Current New York Catastrophe Exposure**

The hurricane that struck New England in 1938 was the greatest hurricane in this century to affect this area. Most recounts of the event discuss the tremendous wind gusts of up to 183 mph and storm surge estimated at 12 to 16 feet associated with the event. It is estimated that the storm killed at least 600 people and caused over \$306 million of damage.

A January 1999 report by Arkwright Mutual Insurance Company /E.W. Blanch observed that a severe hurricane could strike New York and cause severe economic damage. According to the report, "the northern Atlantic coast faces the potential for infrequent, but devastating, hurricane losses, primarily due to the high property concentration in this region . . . . The New York-New Jersey region is particularly vulnerable to a major hurricane storm surge because of a bend in the coastline known as the 'New York Bight.' A federal computer model used to establish evacuation plans revealed that a major hurricane storm surge which struck this unique coastal area could trap many people in the region." The report found that if the 1938 hurricane struck today it could result in as much as \$45.5 billion in economic losses, significantly higher than the economic loss (as opposed to insured loss) realized from Hurricane Andrew. The study

did not provide analysis on the probability or frequency of an event as large as the 1938 hurricane.

The \$45 billion in economic loss should be qualified. First, the estimate includes all loss and is not an estimate of hurricane windstorm losses as insured by the industry. According to Applied Insurance Research (AIR), a catastrophe computer modeling entity, "estimates of total economic losses relative to insured losses range from 5 to 1 for small events to slightly less than 2 to 1 for severe events." For example, the Arkwright/E.W. Blanch study estimates that the economic loss from Hurricane Andrew is approximately \$25 billion, significantly higher than the actual insured losses. In New York, a large portion of the economic losses would be produced by storm surge and flooding, which is mainly covered under the federal insurance flood program. Second, the \$45 billion estimate does not distinguish between residential and commercial losses or between insured losses in Connecticut, Massachusetts, New Jersey, New York, and Rhode Island. Residential insured losses in New York would be a minor portion of the overall economic loss.

Finally, the 1938 hurricane was a strong Category 3 hurricane that occurred during an incoming high tide. Based on AIR's computer model estimates of the 1938 hurricane, the total insured loss for all lines of insurance today would be \$17 billion for the entire Northeast. AIR also estimates that this loss amount for the Northeast is roughly at the one hundred and fifty year return period.

The results of Risk Management Services (RMS) 1998 study for Willis Faber North America, Inc. examined the insured loss potential for New England to the hurricane peril, specifically focusing on New York State's vulnerability to loss. If a storm of the magnitude of the 1938 hurricane were to occur today, it is estimated the total insured loss in New York would be in excess of \$4.0 billion.

### C. Historical Losses

According to the Property Claims Services, there have been 124 catastrophic events since 1949 that have affected New York. Losses from these events are estimated at \$16.2 billion. Of the 124 events, 12 were hurricanes that affected New York. This translates to approximately one hurricane affecting New York every four years. Since 1991, New York has not sustained severe losses from a hurricane.

To analyze the significance of these events representing \$16.2 billion in total losses, it is easier to interpret the potential losses if the figures are presented in current dollars. There are many factors that influence the trend of losses, such as population changes, inflation and construction practices. Since much of this data is unavailable in the detail necessary to specifically estimate the impact, we attempted to adjust the losses using a simple construction cost index. The index used is based on the Boeckh Construction Cost Index. Population changes, inflation and other factors will influence the adjusted losses. As such, the adjusted losses provided in this study should be viewed as approximations only.



After adjusting the total losses by changes in construction costs, the total loss from all events that have affected New York since 1949 is estimated at \$26.2 billion. New York's share of this loss is \$3.8 billion or 15%.

In current dollars, the total loss from the 12 hurricane events is estimated at \$7.1 billion. New York exposures contribute 12% or \$0.9 billion to this total loss. The following table shows a breakdown of events and loss by peril.

Description	No. of events	Total Loss* (in billions)	New York Loss* (in billions)
Hurricane	12	\$7.1	\$0.9
All Other Perils	112	\$19.1	\$2.9
<b>Total</b>	<b>124</b>	<b>\$26.2</b>	<b>\$3.8</b>

\*Losses adjusted to current levels using a Boeckh Construction Cost Index.

The following table shows the 12 hurricane events as well as the actual and adjusted losses.

#### Hurricane Losses Affecting New York 1949-1997

Year	Name	Severity	Actual Loss (in millions)		Adjusted Loss* (in millions)	
			New York	Total	New York	Total
1954	Carol	3	\$ 17.0	\$ 136.0	\$ 162.1	\$1,296.7
1954	Hazel	4	10.0	122.0	95.3	1,163.2
1955	Connie	3	2.0	25.2	18.1	228.6
1960	Donna	4	5.0	91.0	36.3	661.3
1961	Esther	N/A	4.3	4.3	30.0	30.0
1972	Agnes	2	23.7	100.1	81.0	341.9
1975	Eloise	3	9.0	119.2	24.5	322.6
1976	Belle	3	11.8	22.7	29.5	56.6
1979	David	3	3.8	122.1	7.6	244.6
1979	Frederic	2	2.5	875.4	5.0	1,498.2
1985	Gloria	3	172.5	418.3	236.8	574.8
1991	Bob	3	115.0	620.0	134.4	724.6
<b>Total</b>			<b>\$376.7</b>	<b>\$2,650.0</b>	<b>\$960.6</b>	<b>\$7,143.1</b>

\*Losses adjusted to current levels using a Boeckh Construction Cost Index.

#### D. Projected Modeled Losses

The sum total of all property insurance premiums reported to the National Association of Insurance Commissioners (NAIC) for New York in 1996 is \$3.6 billion. This is the sum total of premiums reported in the fire, allied lines, farmowners, homeowners and

commercial multi-peril (non-liability) lines of insurance. This figure does not include any reported auto physical damage premiums.

The impact of hurricane events on the estimated total insured exposures in New York can be simulated through catastrophe models. Using modeled output, a probabilistic perspective on the likelihood of losses of different severities can be estimated. This likelihood of severe loss is most often provided in the form of a PML or Probable Maximum Loss.

The following table shows the results of simulating thousands of hurricanes across the estimated property insurance limits in New York. Risk Management Solutions, Inc. calculated the estimates using its proprietary IRAS Hurricane model, version 3.6.

Probable Maximum Hurricane Loss	
Return Time (years)	Estimated Loss (in billions)
5,000	\$16.2
1,000	10.7
500	8.7
250	6.2
100	3.9
67	3.2
33	1.6
20	0.7
10	0.1

The IRAS model estimates that a \$3.9 billion hurricane insured loss in New York has a probability of occurring once in 100 years. Likewise, a \$100 million hurricane loss is estimated to occur once every 10 years.

#### E. Section Summary

After Hurricane Andrew and the Northridge Earthquake, the insurance industry utilized catastrophe computer modeling to estimate future catastrophic events. A 1996 Natural Disaster Coalition (NDC) study estimated that a 1-in-250-year hurricane striking Miami would produce \$36 billion in residential insured losses and \$55.9 billion in total insured losses. Commercial property insured losses from an earthquake would also be severe. The NDC study concluded that a major California earthquake (with fire following) would produce \$18.9 billion in residential property insured losses and \$52 billion in total insured losses. Comparable New York estimates are dwarfed by those for Florida and California.

Historically, a hurricane has affected New York once every 4 years. Adjusted losses from these events range from \$30 million to as much as \$1.5 billion. These losses have been from relatively moderate events. Population growth and inflation suggest

that the losses from these historical events may be more severe if they were to occur today.

Based on computer simulation modeling, hurricane losses for the 1-in-100-year event is estimated to be \$3.9 billion for both residential and commercial losses in New York State. For the 250-year event, the losses are estimated to be \$6.2 billion for both residential and commercial losses. The insurance industry has already withstood similar catastrophic events and is better prepared today to sustain events as great as Hurricane Andrew and the Northridge Earthquake.

#### IV. Strength of the Private Market

##### A. Primary Insurer Capacity

As 1999 begins, the surplus of the property-casualty insurance industry available to pay claims stands at record levels. With good investment returns in recent years, better loss experience in many lines, and moderate catastrophe losses, the surplus or capacity of the industry has increased at double-digit levels since 1995. The following table shows the trend that has significantly increased the capacity of the industry to write new and renewal business over the past five years. Since 1990, the industry's surplus has doubled.

Year	Year-End Surplus (in billions)	Change From Prior Year
1994	\$193.1	6.0%
1995	230.0	19.0
1996	255.6	11.1
1997	308.5	20.7
1998	342.0	10.9

Sources: A.M. Best, Insurance Services Office (ISO)

Since 1994 when surplus and capacity was increasing modestly due to the impacts of Hurricane Andrew and Northridge earthquake, surplus has risen by 77.1%. The property-casualty insurance industry survived an extremely challenging 16-month period from September 1992 to January 1994 with Hurricanes Andrew, Iniki, the Northridge earthquake and other significant catastrophes that totaled nearly \$35 billion in losses. However, due to significantly larger capacity and five years with light-to-moderate catastrophe experience, the industry is in a much stronger position today to handle a 250-year New York/New England hurricane than it was earlier in this decade.

Projections from modelers indicate that maximum personal and commercial property insurance losses from a 250-year storm striking New York would be in the range of \$6 billion. This amount is easily within the industry's current capacity to absorb, and is significantly smaller than the catastrophic losses handled by the industry from August

1992 through January 1994 when industry-wide surplus was only about 55% as large as it is today.

The New York home insurance market is large and very diversified with \$2.12 billion in annual premiums. The A.M. Best 1997 experience by state and line study lists 138 active home insurers in New York. Unlike some states where the top three writers and a property residual market (FAIR or Windstorm Plan) account for 60% or more of the market, the New York market has a better spread among major companies. The largest home insurer in New York holds a market share of about 16%, whereas in a majority of other states in the U.S. the top writer has a market share of 20% or more, and in some states the largest writer's share exceeds 30%. The top ten writers hold about two-thirds (67%) of the market, but there are more than 100 companies writing the remaining third. This will help distribute losses from a catastrophe among a large number of writers, even before extensive reinsurance capacity is tapped.

### **B. Reinsurance Capacity**

According to reinsurance broker, Willis Faber Re, there is a current overabundance of reinsurance capacity without counting capital markets capacity. Swiss Re's publication Sigma reported that in 1997, \$53 billion of catastrophe excess of loss cover was bought worldwide, 31% more than in 1994; \$18.5 billion was purchased in the U.S. In 1998, \$22.2 billion of catastrophe excess of loss cover was purchased in the U.S. On average, however, according to reinsurance broker US Re, only some \$7 to \$10 billion of such coverage was available in any one geographical region for all property catastrophe excess related loss, including residential, with the insurance industry retaining an average of \$2 to \$3 billion of a property catastrophe loss occurrence prior to catastrophe excess reinsurance protection being triggered.

In addition to the catastrophe excess reinsurance, additional reinsurance from facultative, proportional, per risk excess and per occurrence excess contracts provide resources to manage major catastrophic losses. These products add capacity beyond that available from catastrophe excess reinsurance. According to reinsurance broker Guy Carpenter's November 1998 publication the Monitor, companies can purchase traditional catastrophe excess cover above \$500 million per event, per insurer, as compared to \$200 million in 1992. Average retention in 1998 was \$275 million, up from \$125 million in 1992. Once again, the catastrophe excess cover does not include other traditional forms of reinsurance that provide catastrophe protection. It also does not include capital markets products that provide additional capacity.

According to Willis Faber Re, the factors driving this healthy market are: the new number of participants such as Arrow Re, Lehman Re, and Chubb Re, plus the Bermuda market and the re-emergence of the London market; mergers and acquisitions – as reinsurance companies get larger and stronger their appetite for risk increases; strong investment portfolio; and absence of a major single catastrophic event. In addition, Bermuda markets indicate that capacity will increase further if rate levels match their indications. In January 1999, State Farm and Renaissance Re

announced the formation of Top Layer Re, which will provide \$3 billion in high level excess cat cover for non-U.S. business. Even though the cover is not available for U.S. insurers, it is a sign of continuing growth in reinsurance capacity. Reinsurance is a worldwide business and the source of reinsurance capacity retains a healthy diversity: one-third Europe; one-third U.S.; and one-third Bermuda.

According to Guy Carpenter's September 1998 *Global Reinsurance Analysis*, the relatively high level of capitalization is indicated by the premium-to-surplus ratio, which now stands at 0.67, which means that every 67 cents of premium is supported by a dollar in capital. This signifies a very healthy market, especially compared to the standard for regulatory action, which is \$3.00 of premium as supported by \$1.00 in capital.

1998 saw another dramatic decrease in the pricing of catastrophe reinsurance in the United States. The high level of excess capacity is driving down the price of reinsurance for all lines. Reinsurance broker, Willis Faber Re, in its presentation to the Panel stated that reinsurance is a buyer's market and will be for the foreseeable future. Guy Carpenter's *Monitor* states that the rate for catastrophe excess contracts has now declined five years in a row; the rate on line dropped 17.5% in 1998, following a 20% drop in 1997. Catastrophe reinsurance rates are now below the 1992 levels on an "un-adjusted" basis. Paragon Reinsurance Risk Management Services, a subsidiary of reinsurance broker, E.W. Blanch, produces a U.S. catastrophe index twice a year. The index is down 34% since July 1994.

In sum, there is an overabundance of capacity in the reinsurance market without counting capital markets capacity, the catastrophe pricing is being driven down by the high level of excess capacity; and larger catastrophes are more easily absorbed by reinsurers without market contraction.

### C. New York Property and Casualty Insurance Security Fund

In case of a major hurricane striking New York, the New York Property and Casualty Insurance Security Fund (Security Fund) may be called upon to cover claims of any insolvent insurers. The Security Fund is created by statute. The primary purpose of the Security Fund is to pay claims to New York policyholders of insolvent property and casualty insurance companies. These claims are paid from assessments on net direct written premium on policies insuring property or risks located or resident in New York for the lines of business as listed on page 15 of the Annual Statement (as submitted by insurers to the New York Insurance Department).

In addition to its assessment authority, the Security Fund must hold moneys. If the net value of funds dips below \$150 million, insurers are assessed quarterly to replenish the fund. In 1998, the fund assessed insurers for the first time since 1982.

After Hurricane Andrew, several small companies became insolvent generating in excess of \$400 million in claims for the Florida Insurance Guaranty Association (FIGA).

In December 1992, the Florida Legislature responded in a Special Session by authorizing FIGA to issue up to \$500 million in tax-exempt bonds. These bonds, issued in February 1993 through the City of Homestead were repaid by a special assessment of 2 percent. By June 30, 1993, about \$430 million in claims had been paid.

Like catastrophe state funds, the Security Fund relies upon a build up of moneys. Besides available funds, a certain level of post-event financing would be available through the Security Fund and could be used after an event. New York is already familiar with issuing large tax-exempt bonds. For example, New York City has issued about \$22 billion in tax-exempt bonds since 1995. Like the FIGA after Hurricane Andrew, it is reasonable to assume that the Security Fund could be authorized to issue bonds if it were necessary to pay claims of insolvent insurers.

#### D. Accessing the Capital Markets

Over the past few years, innovative investment structures increasingly have been used to attract traditional investors into funding catastrophe exposures. These structures evolved from and were made possible by statistical techniques used to evaluate and price risks of high yield securities, and the increasing sophistication in predicting weather and seismic events. Capital markets are used to dealing with significant unexpected variations in value (i.e. risk) and natural disasters are a manifestation of risk that can have financial consequences to the value of assets. For example, *the daily variation in market value of New York Stock Exchange traded stocks exceeds the largest catastrophe currently expected.* If a small portion of the seventeen trillion dollars invested by capital market investors could be attracted to fund catastrophe exposures, greater depth, stability and pricing efficiency could be brought to the property catastrophe insurance sector. This section discusses the growing application of capital market instruments for funding catastrophe exposures and identifies changes in public policy that can facilitate further evolution of this important source of catastrophe funding.

The market for capital markets funding of catastrophe natural exposures has grown from one transaction in 1994 totaling \$85 million to eighteen transactions in 1998 totaling over \$3 billion. The development of this market is not too different from the evolution of the multi-billion dollar mortgage securitization market in the late 1970's. While it is still in its infancy, a lot of resources are being directed by capital markets intermediaries to encourage development of the market and to complete a growing number of transactions. Arguably, this development could revolutionize catastrophe insurance funding and greatly expand the capacity of the U.S. insurance market to deal with the financial risk attendant to large catastrophes. A list of recent transactions is included in Appendix D.

#### 1. Securitization

In general, this is a method of combining ownership of assets or rights to economic value from individual contracts into an investment contract. The underlying asset or

contractual right is the source and collateral for repayment. As such, the economic risks and rewards of ownership flow through to the ultimate investor in the security. Assets or contracts are typically held in trust for the benefit of investors, and cashflow therefrom is disbursed under contractual terms for payment of investment obligations.

A typical structure used to apply principles of securitization to the funding of catastrophe exposure includes granting to investors certain rights to cashflow (premiums) from a reinsurance contract between one or more primary insurers and a special purpose reinsurance company (SPRC). This SPRC is formed for the sole purpose of reinsuring the exposure to be funded by capital provided by traditional capital markets investors. Investors purchase securities from this SPRC, the proceeds from which are held in trust and invested in high-grade securities. The funds held in trust may be released to cover costs related to catastrophes, per the terms of the reinsurance contract. To the extent not used under the terms of the reinsurance contract, funds may be used to pay obligations to investors. Interest from the assets held in trust and premiums from the reinsurance contract are sufficient to provide a return to the investors in the SPRC for the repayment risk assumed in the transaction. Through financial re-engineering, rights to the cashflows from the reinsurance contract and the interest from assets held in trust may be stratified and prioritized such that the terms of some of the securities include a full contractual obligation to repay principal and interest and other securities may carry only a contingent obligation.

Under current U.S. tax law, the SPRC would be considered a separate business entity subject to corporate tax, and then the income on securities at the investor level would also be taxed. This double taxation so adversely affects the economics of these transactions that the SPRC must be incorporated and operate in a non-U.S., tax-advantaged jurisdiction. Otherwise the transaction would be uneconomic.

Nationally recognized credit rating agencies have begun to evaluate the risk attendant to some of these structures and have awarded investment or non-investment grade debt ratings to the related securities.

## 2. Insurance Exchanges

The CATEX utilizes traditional reciprocal reinsurance concepts arranged through a new cyberspace trading exchange. Using an electronic mailbox system, CATEX risk-bearers and their brokers negotiate and complete trades which swap a portion of one company's catastrophe exposures for another's (e.g., units of Florida hurricane risk could be exchanged for units of California earthquake risk). All contracts are expected to be individually negotiated by the parties.

In theory, CATEX provides insurers a means of diversifying their geographic risks and could be attractive both to companies wishing to divest themselves of undesirable risk concentrations, and to those who wish to assume a moderate amount of risk beyond their traditional coverage area. Unlike debt/equity financing, CATEX offers primary

insurers reinsurance accounting treatment on their financial statements. To date, interest in CATEX by national property insurers has been steadily increasing.

Recently, the Illinois Department of Insurance approved an expansion of INEX's regulations to allow insurers and reinsurers to form special purpose limited syndicates on the exchange to conduct insurance securitizations. These special purpose syndicates, which are subject to the oversight of both the INEX Board of Trustees and the Illinois Department of Insurance, can operate under unique capital and filing requirements reflecting their limited businesses. A major element of the new regulation is the requirement of a fully collateralized trust to secure all obligations.

### **3. Surplus Notes and Capital Notes**

Among the first major capital market catastrophe insurance deals was the \$400 million in contingent surplus notes arranged by Nationwide in February 1995. Notes are special forms of debt instruments which, due to restrictions on their repayment terms are accorded certain degrees of equity treatment for insurance solvency regulation purposes. The rules governing these instruments are included in state insurance law and regulations which generally conform to model laws, risk-based capital formulae and accounting treatment adopted by the National Association of Insurance Commissioners. To qualify as a Surplus Note or a Capital Note, debt instruments must meet certain criteria as to maturity, amount outstanding and the financial condition of the issuing insurer. Repayment of principal and interest on Surplus Notes requires advance approval, subject to specified criteria, of the chief insurance regulatory official of the state in which the insurer is domiciled. Capital Notes do not require advance regulator approval for payments of principal and interest as long as certain conditions are maintained.

Qualifying Surplus Notes are listed in the insurer's capital account and are deemed as Surplus for various regulatory solvency ratios, including minimum legal capital calculations. Qualifying Capital Notes are listed as debt on the insurer's balance sheet, but are added to surplus in determination of an insurer's risk-based capital calculation for minimum regulatory capital purposes.

Issuance of Surplus Notes is commonly provided for under many state laws. The regulatory parameters governing the issuance of Capital Notes have only recently been adopted by the NAIC. Enabling legislation or regulations may be required to allow issuance of Capital Notes in a particular state.

These instruments can be issued by an insurer in advance of a catastrophe to pre-fund exposures or an insurer can enter an agreement to issue these instruments on a contingent funding basis as a post-event funding mechanism. In either case, they represent important tools for accessing the capital markets for catastrophe exposure funding.



#### 4. Non-Traditional, Expanded Reinsurance

Variations on traditional forms of reinsurance have emerged in response to the need for insurers to meet regulatory requirements, qualify for favorable accounting or tax treatment and attract additional investors to fund catastrophe exposures. To the extent that these variations actually expand existing or attract new sources of capital to fund catastrophe exposures or facilitate more efficient deployment of existing capital, they may also be viewed as capital markets solutions.

Using the above techniques and instruments, cedents and investors now enjoy a continuum of opportunities to access and employ investment capital. Capital can be accessed by cedents and employed by investors on a contingent, debt capital, equity capital and pure risk basis, with gradations between each of these points on the continuum to allow specific tailoring of transactions to unique needs. Investors and cedents have become very sophisticated in the structuring of portfolios of assets and exposures with various complementary risk characteristics. Cedents have become comfortable with capital markets instruments and investors have begun to accept natural disaster catastrophe-linked securities as a valuable part of their portfolios.

#### 5. Benefits of Capital Markets Instruments

Expansion of capital markets funding alternatives for catastrophe exposures has proceeded rapidly, as investors have become more comfortable with assessing the catastrophe risk of particular cedents. At the same time cedents have developed the ability to assess the benefits and preferred structural characteristics of alternative funding proposals. The benefits to cedents, policyholders, regulators and investors can be categorized into the following broad groups. These benefits may be present to a greater or lesser degree, or may not pertain at all to a specific structure, depending on the terms and conditions of the particular deal.

- **Diversification of Sources:** Additional sources of risk capital have been generated by these transactions over and above the traditional sources of insurance risk capital.
- **Additional Capacity:** The ability of cedents to attract other risk capital to support catastrophe exposures frees up existing capital to support additional business.
- **Multi-Year Coverage:** Traditional capital markets instruments have maturities ranging from days to decades which can translate into multi-year risk transfer product, reducing the complexity to cedents and allowing greater flexibility and stability in structuring catastrophe management funding programs.
- **Stable Pricing:** Capital markets instruments tend to be priced efficiently. As the newness premium of these instruments disappears, cedents and policyholders will benefit from a more open, competitive market for risk capital.

- **Availability, Affordability, Reliability of Catastrophe Insurance:** Policyholders of primary insurers and regulators benefit from capital markets funding of exposures to the extent that additional capacity and efficient pricing translate into improved availability and affordability of catastrophe insurance, greater solvency of insurers and enhanced stability of the market for primary insurance. The willingness and continuing ability of primary insurers to provide catastrophe insurance and, therefore, the ability of policyholders to obtain and afford such coverage can be enhanced if these market efficiencies can be transferred to the policyholder. This presumes that pricing of capital markets instruments will be seen as acceptable to regulators in the ratemaking process.

## 6. Legal Impediments

As promising as securitization of insurance risk has been in accessing the capital markets for catastrophe exposures, there are significant unresolved legal barriers to expanding this market and making it generally available to insurers. Existing federal tax and insurance regulatory issues require complex structures to make these transactions economic. This has retarded the proliferation of an otherwise promising market.

As a result, many securitization transactions are private, highly structured and involve only a few sophisticated investors. Recent large transactions, which have been structured to successfully navigate a path through complicated state regulatory issues and have avoided federal tax issues, are encouraging exceptions to this pattern. Legal and regulatory processes have begun to address those issues, but significant barriers and uncertainties remain. The 1998 report of the Temporary Panel detailed the proposed changes in the federal tax law needed to promote an efficient structure. The intent of those changes would be to designate special purpose reinsurers as pass-through entities that would not be taxed as a separate corporation.

The NAIC has awarded risk-based capital bond classification status to such securities which receive a fixed-income rating from a Nationally Recognized Statistical Rating Organization (NRSRO). This causes investments of this sort to be more attractive to insurers because, under insurance risk-based capital rules, they will have to hold less capital to support them. Additional changes to state insurance and regulations and statutory accounting requirements are currently being addressed by the National Association of Insurance Commissioners Insurance Securitization Working Group with the intent to facilitate the development of this important funding source.

Capital Markets can be an important source of sophisticated funding of catastrophe exposure, employing a virtually limitless array of instruments to transfer risk across a vast capital base. Securitization of event risk is similar to securitization of other assets and liabilities, which has been routine since the seventies. The efficiency of pricing and depth of funding will tend to complete the commoditization of property insurance, which can lead to great benefits for policyholders and increased competition in an already fiercely competitive market.



determine whether derivatives can provide a viable alternative for the spreading of insurance risk to the capital markets. These issues include credit risk, appropriate accounting rules, correlation for interest-based products and the different tax treatments between onshore and offshore securitization vehicles.

### c. CATEX

The Catastrophe Risk Exchange, Inc. (CATEX) continues to be licensed as a reinsurance intermediary under New York Insurance Law. Through a highly secure, yet flexible, computer-based trading exchange, CATEX provides a means whereby primary insurers and reinsurers can have access to a wider, more efficient means of distributing their risks.

### d. Proposed Legislation

The New York Insurance Department continues to support legislation authorizing the issuance of capital notes by property/casualty insurers. A capital note is constructed as a debt instrument that is carried as a liability on an insurer's balance sheet, but which may be added to total adjusted capital for purposes of calculating risk based capital. This legislation did not pass in the 1998 New York legislative session.

In addition, the Department is receptive to legislative needed to facilitate securitization of insurance risk through the use of special purpose entities formed to assume insurance risk under single or multiple structured reinsurance agreements from ceding insurance companies. The issuance or sale of securities in the capital markets finances funding of these entities' potential obligations under the reinsurance agreement. Investors in such securities risk loss of principal and/or interest in the event the losses (or other triggering points) specified in the reinsurance contract are realized.

### e. Tax-Deferred Pre-Event Catastrophe Reserves

The New York Insurance Department along with other state regulators have been involved in developing the design of a tax-deductible pre-event catastrophe reserve on a national level. This proposal will promote the safety and soundness of the insurance industry's balance sheet by enhancing the ability of the insurers to fund a major catastrophe. Under current statutory accounting procedures, if there is no catastrophe in a particular year, the portion of the premium collected for that period's catastrophe coverage would be fully earned and taken into surplus. In the case of stock companies, this earned surplus may be distributed to shareholders in the form of dividends. Thus, statutory accounting procedures discourage property & casualty insurers from accumulating assets specifically to pay for future catastrophes and from expanding capacity to handle larger catastrophic events.

The current catastrophe reserve proposal would require that a reserve be established based on a portion of premiums collected each year for property lines of business. This



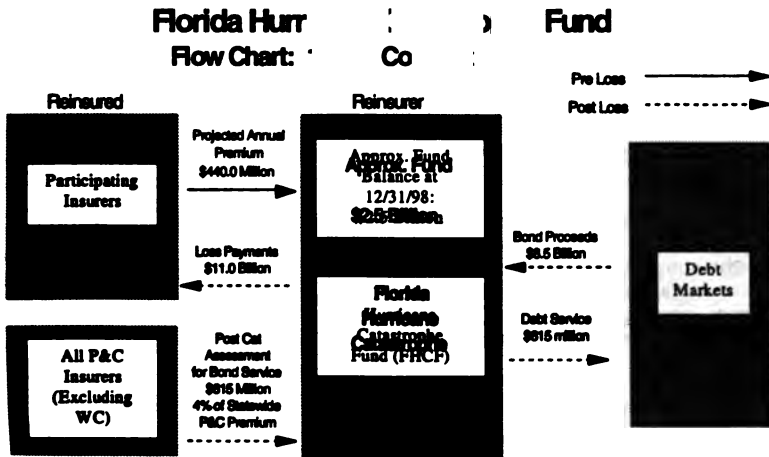
## V. Description of Hurricane Insurance State Mechanisms

### A. Florida Hurricane Catastrophe Fund (FHCF)

The FHCF was created in November 1993 during a special legislative session after Hurricane Andrew. The enabling legislation is codified in Section 215.555, Florida Statutes. The purpose of the FHCF is to improve the availability and affordability of property insurance in Florida by providing reimbursement to insurers for a portion of their catastrophic hurricane losses.

The FHCF is structured as a state trust fund under the direction and control of the State Board of Administration (SBA). Its trustees are Florida's Governor, Comptroller, Treasurer, and Insurance Commissioner. A nine-member advisory council has been created to provide the SBA with information and advice. Paragon Reinsurance Risk Management Services, Inc. is the Fund Administrator as well as the Actuarial Consultant to the SBA. In addition to hiring staff and contracting with other professionals, Section 215.555, Florida Statutes, gives the SBA the authority to adopt rules in order to implement the Statute.

The SBA collects premium from participating insurers, and may use money in the fund only to pay insurers according to the terms of their contracts, and to pay other obligations and expenses as specified in the Statute. The SBA is responsible for investing fund money and has the authority to issue revenue bonds if it determines that additional funds are necessary for reimbursement of losses or if it determines such action would maximize the ability of the fund to meet its future obligations. The following flow chart summarizes the economic structure of the FHCF.



The 1998 annual reimbursement premium collected from participating insurers will be added to the current FHCF balance, resulting in an approximate balance of \$2.5 billion as of December 31, 1998. If additional funds are needed to pay losses, the SBA may enter into agreements to issue bonds. The bonding capacity of the FHCF as of May 1998 has been estimated at \$8.5 billion. Adding the December 31, 1998 projected FHCF balance of \$2.5 billion gives an estimated total of \$11.0 billion available to pay losses.

If the SBA determines that reimbursement premium from participating insurers is insufficient to fund its obligations and expenses, it may levy an emergency assessment on each insurer writing property and casualty business in the state. Such assessments cannot exceed 4% of insurers' gross direct written premium for property and casualty business in Florida excluding workers' compensation.

All authorized insurers in Florida, including the Florida Residential Property and Casualty Joint Underwriting Association (RPCJUA) and the Florida Windstorm Underwriting Association (FWUA), which write covered policies in Florida, are required by Section 215.555, Florida Statutes, to enter into a Reimbursement Contract with the SBA.

During 1994, the first year of operation, approximately 380 companies were members of the FHCF. As indicated below, the number of participants decreased in 1995 when commercial business was no longer covered with the exception of commercial residential business.

Contract Year	Participating Companies
1994	378*
1995	289
1996	290
1997	301
1998	292

\*Includes commercial-only writers

The FHCF applies to any storm declared to be a hurricane by the National Hurricane Center, which causes insured losses in Florida, both while still a hurricane and throughout any subsequent downgrades in storm status. Tropical storms that do not become hurricanes are not covered. Coverage is on a per occurrence basis. Only hurricane losses are subject to reimbursement by the FHCF, and an insurer may have exposure to other types of catastrophic losses (e.g., hail, tornado, earthquake, flood, etc.).

The FHCF has paid out to insurers \$13.5 million in total estimated incurred losses. In 1995, total estimated FHCF incurred losses were \$47,672 for Hurricane Erin and \$13,372,084 for Hurricane Opal. Hurricane Opal produced \$2.1 billion in total insured losses and Hurricane Fran produced \$1.6 billion in total insured losses. The 1998

Hurricane Georges resulted in \$10,147 in incurred losses based upon the interim loss report.

The Reimbursement Contract, along with an initial premium invoice, is mailed to each participating company prior to June 1, the beginning of the contract year. At that time, each company must also elect a reimbursement percentage of 45%, 75% or 90%.

Insurers are required to pay an annual reimbursement premium to the FHCF, based on an actuarial formula specifying the amount of premium to be paid for each \$1,000 of insured value for covered policies in each 5-digit Florida ZIP Code by type of business, construction class and deductible group. The SBA retains an independent actuarial consultant to develop the reimbursement premium formula and the rates to be used in determining the annual reimbursement premium due from each insurer.

To develop the annual reimbursement premium and make other hurricane exposure estimates, FHCF uses catastrophe computer modeling. There are two fundamental reasons for using computer modeling in developing rates: (1) low frequency peril and (2) changing exposures. In both cases, relying on historical experience (even with loss trends) would not produce realistic rates. The historical time period may not be long enough to generate a realistic sample of possible events. Aggregate insured losses from past years, when the population was lower, would tend to be lower than losses from similar events today, simply because there were fewer exposures at the time of the historical events.

The FHCF uses loss costs based on 50,000 simulated years of weather (hurricanes) applied to current Florida residential exposures. Insured loss costs are generated to meet statutory and various insurance coverage combinations. The actuarial consultant loads these results for expenses and other non-model factors to generate rates.

In addition to rating factors, the coverage level chosen by the company is considered in the final premium calculation. Premium for a company choosing 45% coverage is one-half of the premium at the 90% coverage level. Finally, it should be noted that premium calculation and exposure reporting procedures may differ for companies that begin writing covered policies after the beginning of the contract year.

As the reimbursement premium formula is developed for the contract year, a retention multiple is established for each coverage level. A retention is the amount of losses that the insurer must retain before the FHCF covers the insured losses above the retention. A company's retention is calculated by multiplying its annual reimbursement premium by the multiple corresponding to the selected coverage level.

Losses reimbursable under the FHCF from hurricanes during a particular calendar year will not be paid until the following year, although Section 215.555, Florida Statutes, provides for discretionary advances in the interim for insurers that may become insolvent without earlier payment, and for the JUA's and limited apportionment companies which meet certain criteria.

Reimbursement of subject losses is limited by the claims paying capacity of the FHCF. Thus, there is no identified limit of coverage. Given a major catastrophic event, the amount of reimbursement from the FHCF may be partially limited by funds available to cover reimbursable losses. A methodology has therefore been established for risk management purposes.

As illustrated in the flow chart, the claims paying capacity of the FHCF is the total of the current FHCF balance and the bonding capacity of the FHCF. This was most recently calculated as follows:

12/31/98 Projected Fund Balance		Estimated Bonding Capacity		Estimated Claims Paying Capacity
\$2.5 billion	+	\$8.5 billion	=	\$11 billion

If the bonding estimates do not change, the FHCF should increase to \$11.6 billion by the end of 1999. Should the FHCF's claims-paying capacity be insufficient to reimburse all companies to the full extent of their subject losses, the projected payout multiple becomes a factor in calculating FHCF recovery.

#### **B. Hawaii Hurricane Relief Fund**

In 1992, less than a month after Hurricane Andrew devastated the Florida and Gulf Coasts, Hurricane Iniki struck the Hawaiian island of Kauai, causing \$1.6 billion in insured losses. Due to Hawaii's unique geography and demographics, a comparable storm (Category 3) could have caused significantly more damage if it were to hit the more densely populated island of Oahu. Concern about the domestic insurance industry's ability to handle such a loss led to the enactment of the Hawaii Hurricane Relief Fund (HHRF) in 1993. In April 1996, the IRS granted tax-exempt status to the fund.

HHRF is a state agency operating within the Department of Consumer Affairs. The facility offers hurricane coverage to all homeowners in the state of Hawaii. Insurers writing business in the state who choose not to write hurricane peril act as servicing entities and issue policies on behalf of HHRF. Insurers are subject to assessment, based on market share. The assessment is capped at \$500 million.

#### **Claims Paying Capacity:**

\$750 million Credit Facility (Administered by Bank of Hawaii)  
 \$600 million Reinsurance (Traditional and Finite Risk)  
 \$600 million Assessments (On servicing insurers)  
 \$90 million Paid-in-Capital (Total Assets \$135 million)



Sources of Financing: Credit facility and a portion of reinsurance are supported by current premium income. Additional revenue is generated from a special mortgage recordation fee. There also is a quarterly assessment of 3.5% on all property-casualty premiums, excluding auto, health and workers' compensation. It is currently assumed that the Fund can handle a \$1.5 billion loss. If the available funding is exhausted, claims are paid on a *pro rata* basis, with the unpaid portion to be paid as soon as available funds are collected from an annual 7.5% insolvency surcharge on property-casualty policyholders.

When the HHRF was enacted, its goal was to begin building a surplus for future catastrophes. However, Hawaii has failed to set premiums at a high enough level to create a surplus.

The HHRF also permits an opt-out for insurers. Recently, State Farm filed to opt-out of the HHRF effective March 1, 1999. As a result, the purpose of the HHRF has come into question and the state may reevaluate its need.

## **VI. Alternative Potential Resources to Fund Catastrophes**

To provide a full discussion on the catastrophe issue, the Subcommittee has summarized two alternative potential resources to fund natural catastrophes. First, one Panel member has presented the merits of permitting insurers to set aside federally tax-exempt catastrophe reserves. Second, another Panel member has outlined possible structural changes to the Florida fund in order to maximize its flexibility. The Subcommittee did not take a position on these alternatives.

### **A. Tax-Deferred Pre-Event Catastrophe Reserves (Policyholder Disaster Protection Coalition\* Proposal)**

It is relatively clear that the Florida, California and Hawaii responses to disaster insurance protection have all evolved around the principal that funds need to be accumulated on a tax-free basis. (The California Earthquake Authority is not examined in this report.) In the case of the Florida and California funds, acknowledgement by the Internal Revenue Service that funds would be accumulated without adverse tax consequences to participating insurers was the absolute *sine qua non* for implementation of both mechanisms. All of the catastrophe insurance bills introduced in the last New York legislative session revolved around the idea that funds collected either from policyholders or insurers would be set aside and would be allowed to accumulate along with interest without generating counterproductive tax liability for participating insurers. It was assumed that taxation of these funds would eliminate any

---

\* The Policyholder Disaster Protection Coalition is a coalition of small businesses, nonprofit organizations, elected officials, insurance providers, policyholders and citizens concerned with disaster planning. The PDPC is working toward formulating private market solutions to disaster preparedness by encouraging insurers to specifically set aside some policyholder payments for future disasters.

- **Industry Stability and Policyholder Security** – More capital will be dedicated to cover catastrophe exposures – an estimated \$19 billion pre-funded reserve built within the first ten years. This should result in greater stability in the industry and fewer catastrophe induced insolvencies and less exposure to guaranty fund assessments. In combination, these benefits would act as a buffer to reduce market shocks in the aftermath of a major catastrophe. Those shocks have resulted in insurers seeking to withdraw from highly exposed key markets and have given rise to the need to consider alternative approaches, including state pools.
- **Effective, Efficient Risk Diversification** – Insurers are effective and efficient diversifiers of risk across a broad geographical area. In comparison, State pools tend to concentrate catastrophe risk among the policyholders of a single state. The Reserve would provide the incentive for insurers to save in advance for mega-catastrophes while preserving the benefits of broad diversification available through the established insurance marketplace.
- **Reduced Reliance on Government and Industry Bailouts** – When an insurer becomes insolvent, its policyholders are often helped through: (i) guaranty funds (assessments of surviving insurers which ultimately are paid by policyholders of surviving insurers or state taxpayers), or (ii) taxpayer-funded government assistance. Increased industry ability to handle major catastrophes should translate into fewer insolvencies and less possibility of taxpayers and other policyholders having to bail out an ill-prepared insurance company. This proposal would make it possible for, and encourage, insurance companies to be prepared before a major disaster strikes.

#### **Operation of the Reserve**

- Generally, the Reserve funds would be held by the insurer in a segregated account and subject to a cap. The amount of the cap would be calculated for each insurer as a percentage of the insurer's writings in exposed property lines. Actual funding of the reserve would be based on the insurer's catastrophe exposures for its qualifying lines of property-casualty business. The Reserve funds would be set aside on a tax-deferred basis. In the year funds are drawn down from the reserve, they would be included in the determination of an insurer's federal tax liability for the year.
- An insurer could reduce the Reserve only to cover actual losses associated with a qualifying event as designated by the Property Claims Service, the President of the United States or by the chief executive of any state, territory or possession of the United States. Qualifying events include: wind (hurricanes, cyclones, tornadoes); earthquake/fire following; winter catastrophes (snow, ice, freezing); fire; tsunami; flood; volcanic eruption or hail. The Reserve also could be decreased by the order of a governmental regulator to forestall insolvency.

- The allowed maximum Reserve would be phased in over a 20-year period. Five percent of an insurer's cap could be set aside in the Reserve in the first year and five-percent increases would be allowable during each of the remaining years of the phase-in period.

While many in the insurance industry have long acknowledged that catastrophe reserves are in theory the most desirable method of funding potential liability for natural disasters, federal budget politics impose a significant barrier. Congress would need to approve a change in U.S. tax law to allow the deferral of taxes on the Reserve. This would be subject to balanced budget rules that require reductions in federal tax revenues to be offset by accompanying increases in revenue or by expense reductions. To the extent that these rules allow a tax revenue reduction to be offset by the federal budget surplus, that could also be a resource. A preliminary estimate of the official ("static") revenue effect of the Reserve showed a reduction of about \$5 billion over 10 years, or \$500 million per year.

#### B. Variation of FHCF (US Re Proposal)

The following proposal is for a New York Wind Catastrophe (Reinsurance) Fund (the Fund) modeled to an extent on the Florida Hurricane Catastrophe Fund (FHCF) with several considerable differences. Its intent is to provide a state sponsored but private sector solution to the economical availability of current and/or future insurance capacity for a major catastrophic event. This proposal is offered by one of the Panel members as an illustration of possible structural changes to the FHCF which may make a single-state focused reinsurance fund more flexible and therefore more attractive to the insurance community. It is not yet certain how much of the insurance community would participate in the proposal. Any such solution should be one that qualifies for federal tax-exempt status and it is hoped that the entity would be considered "an integral part of the state" because the state would administer the fund and exercise its taxing authority to support it.

The Fund would act as a reinsurer to individual insurance companies, similar to that of the FHCF, except that:

- The Fund would be voluntary to insurers, not compulsory, so recoveries would be available only to those companies which subscribe to the Fund. This would avoid having insurers, who do not write in hurricane exposed areas, being forced to support other companies who do.
- The Fund would provide protection for all property losses, not just residential losses. This would make it easier for the insurer to determine how to appropriately protect itself with private sector reinsurance in a major catastrophic event.
- The Fund would provide protection only for losses arising out of a Class III (Saffir-Simpson Scale) Hurricane or larger. Events of this magnitude cause serious insured loss. The estimated loss from such events and their impact on a company's

earnings, etc., are a major driving force behind insurance company management's focus on the redistribution of their writings and market capacity. Notwithstanding this, the Fund would only respond to any single insurer's gross occurrence loss once it exceeded the greater of 250% of the insurers property insurance premiums or 20% of its net worth. These percentages are open to change, as the intent is to encourage the insurer to use the available private sector reinsurance market to control its ultimate loss if it so chooses.

- The initial and ongoing funding of the Fund will come from several sources:
  - 1) Insurance companies, who would make a capital contribution and allocate a portion of their ongoing pre-tax profits, which would be considered a capital contribution and which they would be able to carry as an investment asset on their balance sheet.
  - 2) Original insured policyholders, who would pay a modest annual insurance premium surcharge, commensurate with their exposure, for which they will become "preferred" shareholders in the Fund.
  - 3) The State, which would allocate a portion of its premium tax receipts, as well as other areas such as fees derived from property transfer transactions, mortgages, etc.
- out of the above funding sources, the Fund would look to enhance its claims paying ability through the purchase of reinsurance and accessing the capital marketplace.

## VII. The Argument for a Hurricane Catastrophe Fund

*Subcommittee members were divided as to the necessity for a hurricane catastrophe fund in New York State. A small number of Subcommittee members favored the creation of such a fund. This section summarizes this argument, while the argument against the creation of a fund can be found in Section VIII.*

Prior to 1992, Florida thought it had a stable and competitive property insurance market. But then Hurricane Andrew swept through the state, causing \$18.4 billion in insured losses. In all, 11 insurance companies were declared insolvent and the property and casualty joint underwriting association ballooned to 900,000 policies. Prior to 1994, California thought it had a stable and competitive property insurance market. But then the Northridge Earthquake struck the state, causing \$12.5 billion of insured losses. The event financially strained two large insurers, as the 20<sup>th</sup> Century Insurance Company was ordered to reduce its earthquake insurance exposure and Republic Insurance Co. withdrew from the California market. The California FAIR plan – the state residual market – was strained.

Both Florida and California responded to the market crisis after the event by adopting risk-sharing mechanisms unique to their states. Reinsurance availability was restricted

It is suggested that if insurers rely too heavily on the fund, in the long run it may create conditions similar to the market instability after Hurricane Andrew. First, insurers cannot rely too heavily on the fund, unless they are so reckless that the only reinsurance they purchase is from the fund, and that cover is much less than their exposure (but those insurers are likely to be overexposed even without an available catastrophe fund). Second, as articulated earlier, a catastrophe will stabilize the market, not destabilize it.

A catastrophe fund is more cost effective than private reinsurance. This fund does not pay taxes, can issue tax-exempt debt and it has nothing equivalent to the private sector cost of capital. Without considering debt-financing costs in Florida, the catastrophe fund provides \$25 of coverage for every \$1 of premium paid by the insurer. Private reinsurance probably would provide less than \$8 of coverage for every \$1 of premium paid. According to the Paragon Catastrophe Reinsurance Price Index, reinsurance prices increased 75% after Hurricane Andrew. Those prices have fallen since their high around mid-1994, but are still 16 percent higher than pre-Andrew prices.

It has even been suggested that insurers will pay twice for the same reinsurance coverage. It may be true that prudent insurers may purchase a limited degree of overlapping reinsurance coverage, but not because the fund will be unable to meet its obligations. (It will still have its surplus, bonding authority and ability to make assessments to meet those obligations.) Rather, some marginal amount of overlapping reinsurance coverage may be advisable because of the impact that fluctuating interest rates have on reinsurance recoverables. Considering the significant amount of money insurers will save when they purchase reinsurance from the fund, they will consider the cost of any small amount of overlapping coverage to be a very small price to pay.

After five years of operation, the Florida fund has a claims-paying capacity of \$11 billion (\$2.5 billion of cash and \$8.5 billion in debt). This is additional claims-paying capacity that would not otherwise exist. The frequency of events is greater in Florida and it is necessary to build a larger fund than in New York. However, it would be prudent for New York to act, before a catastrophic event, so that the fund has the opportunity to build adequate claims-paying capacity.

Opponents' arguments suggest that the fund's assets will be completely drained by the first catastrophe to come along. That is unlikely, since the fund's capacity would be calculated to withstand a 1-in-100-year hurricane. The chances of a smaller event are much greater and, in fact, if Hurricane Andrew were to strike today, the FHCF's capacity would not be fully depleted.

Last year, the Panel recommended that the federal government change its tax policy regarding catastrophe reserves. Under current law, pre-event catastrophe reserves are not tax deductible and consequently are taxed as ordinary income. Hence, tax policy discourages the build-up of reserves or surplus to pay for large catastrophe losses that may occur in the future. The prospects for a change in federal tax policy are remote. But a state catastrophe fund is a way to build those reserves without being subject to

federal income tax. The tax-free build-up of catastrophe reserves is a key factor contributing to the large claims-paying capacity that currently exists in the Florida and California funds. The economic impact to insurance companies is similar, and we would not have to wait for the federal government to act.

A catastrophe fund can accumulate catastrophe reserves more rapidly than the private market, thereby improving the solidity of the insurance industry. A fund would build surplus and accumulate interest income on a tax-free basis, thereby building capital more rapidly than what would otherwise occur in the private market. This money will be used to protect consumers against catastrophe-induced insolvencies and reduce the exposure to guaranty fund assessments. The fund also would help reduce market instability after a major catastrophe.

Both Florida and California allocate a small portion of their funds for promoting mitigation and for ensuring the state is prepared to respond to a catastrophic event. Such an allocation is generally necessary to ensure that the fund is tax exempt. The expenditure pay dividends in the long run, however, as homes and families become better protected in the event of an emergency event.

A catastrophe insurance fund or other risk sharing mechanism in New York would attract more competition to the property insurance market, increase the total claims-paying capacity of the insurance industry, lower the cost of writing catastrophe insurance, enhance the solidity of the insurance industry, promote a more stable insurance market after a severe event, and encourage homeowners to protect their homes against loss from hurricanes and other natural catastrophes.

The principal argument against a catastrophe fund appears to be based on the state of the current market. There is not a crisis, according to those who oppose a catastrophe fund. The number of new business applications for state-created residual markets is shrinking. They argue insurers are having no difficulty finding reinsurance. The same statements could have been made in Florida and California before severe catastrophes struck those states. Those states subsequently discovered that they were not as well prepared for handling severe natural catastrophes as they thought. Unless New York acts now, it will make the same miscalculation.

The FHC and the CEA were debated and ultimately enacted in pressure-cooker atmospheres created when the absence of affordable reinsurance and uncertainty over future market stability combined to drive insurers out of the market. The resulting legislation was not perfect, and came at great political cost, but both new laws were effective at bringing insurance companies back into the market. Rather than complacently waiting for catastrophic events to overtake the insurance industry and competitive market, the industry should begin now to take control of its own destiny while calmer times provide the opportunity to do so.

### VIII. The Argument against a Hurricane Catastrophe Fund

A state catastrophe reinsurance facility will not make hurricane coverage more available or more affordable in New York. Instead, it will result in cross-subsidization by shifting costs to homeowners and businesses with little or no hurricane exposure. In turn, it will force insurers to purchase reinsurance from a state-run entity, instead of relying on private reinsurance and emerging capital market funding arrangements to spread the risk of loss. In the short-term, it is likely to exacerbate the availability and affordability of homeowners' insurance. In the long-term, the market is still likely to experience instability after a mega-catastrophe.

Opponents argue that a state reinsurance facility benefits insurers who have elected not to purchase reinsurance in the voluntary market as well as those who are reluctant to manage their own capacity problems. However, it also allows those insurers to pass along their problems to responsible insurers and their customers throughout the state.

More importantly, there is no market crisis or availability problem in New York. As a long-term solution to hurricane losses, New York should invest in strong statewide building codes along with their enforcement and voluntary mitigation measures by homeowners to reduce exposure to loss. Along with realistic levels of deductibles, these steps can increase capacity to meet demand.

As precedent, only one state reinsurance fund presently exists - - primarily because of the high level of exposure that Florida continually faces from hurricanes. The Florida Hurricane Catastrophe Fund (FHCF) is part of an extensive legislative response to the severity and frequency of hurricanes striking Florida. In addition to the FHCF, the Florida Legislature improved mitigation measures, strengthened the enforcement of building codes, permitted changes in hurricane coverage such as 2 percent to 10 percent hurricane deductibles, restructured the property residual markets (Florida Windstorm Underwriting Association (FWUA) and the Residential Property and Casualty Joint Underwriting Association (RPCJUA)), allowed catastrophe computer modeling in the ratemaking process, imposed a moratorium on cancellations and nonrenewals, and encouraged new insurers to enter the market. The FHCF was never created to solve all the problems of the Florida homeowners' insurance market and only represents a partial solution to a problem that is potentially more severe in Florida.

In creating a tax-exempt reinsurance state fund (as opposed to a primary insurance catastrophe fund, e.g., Hawaii Hurricane Relief Fund), Florida petitioned the Internal Revenue Service (IRS) for a private letter ruling. A private letter ruling is directed only to the taxpayer that requested it and it is not to be used or cited as precedent. Under section 115 of the Internal Revenue Code, income derived from the "exercise of any essential governmental function and accruing to the State" is exempt from taxation. While there is no set formula for tax-exemption, the IRS's ruling provides guidance.

Failure to receive tax-exempt status for the build up of premiums is devastating to the success of a reinsurance state fund. At a Florida legislative workshop held by former

House Insurance Committee Chair John Cosgrove, he stated that the FHCF fund would have to pay \$165 million in Federal taxes in 1994 on \$407 million raised through reimbursement premium. In addition, he noted that the IRS is very reluctant to grant tax-exempt status if there is linkage between the value insurers receive from the FHCF and the amount of premiums paid by insurers. Generally, the IRS expressed concern that the limited state involvement in the FHCF would make it no different from a private reinsurer.

Ultimately, the Florida Legislature made certain changes to the FHCF which prompted the IRS to determine that the fund is an "integral part of the state" and tax-exempt. The changes were primarily designed to demonstrate the economic involvement of the state. Key points in the IRS ruling are as follows:

The Florida Legislature provided a two-year state contribution to the FHCF in the amount of \$50 million. In addition, the Legislature may annually appropriate at least \$10 million for an expanded range of hurricane mitigation activities. In Standard and Poor's September 1997 rating of the FHCF, they stated that "the IRS looked favorably on the Cat fund based on the commitment of the state and its generous contribution."

Presently, no catastrophe state fund has the "full faith and credit" of the state. By law, neither the funds in a state treasury nor the tax revenue base of the state has been pledged to the payments arising under a state catastrophe fund. Even without this commitment, the IRS has found these entities to be an integral part of the state. To meet losses in excess of any financing program, a state or federal funding solution would be necessary.

To respond to the IRS, the Florida Legislature also increased the emergency assessment. The 2 percent emergency assessment on all property and casualty premium, other than workers' compensation insurance, (which assessments applies only if the FHCF premium revenues are insufficient to pay off its bonds) was raised to 4 percent in instances where the Governor declares a state of emergency arising out of a hurricane. The emergency assessment is automatically passed onto policyholders.

The IRS stated in their ruling that emergency assessments may be collected from non-participating insurers who do not receive any consideration from the FHCF. "By assessing the Non-Participants, the State has effectively exercised its power to collect revenue and appropriate such moneys to the Fund. In relation to other sources of moneys, raised through its exercise of state power to collect payments by Non-Participants, is significant."

The FHCF was created as part of an existing state entity – the State Board of Administration consisting of Florida's Governor, Comptroller, Treasurer and Insurance Commissioner. The FHCF maintains a small staff that manages and implements policy decisions. Moneys in the fund are limited to protecting and advancing the state's interest. The Department of Insurance enforces the rules adopted by the FHCF including the ability to levy emergency assessments. By exercising direct control over



Capacity of the pool, particularly in early years, is based on borrowing capability. Mandatory post-event participation is needed to collateralize repayment of that debt. Yet, the mandatory nature of the FHCF denies insurers writing in the state the right to make their own reinsurance decisions. Insurers that have followed prudent underwriting and managed their catastrophe exposure are rewarded with the additional cost of mandatory participation.

What if the state created a voluntary fund and no one joined? Or, in other words, would insurers have the need to participate in a state fund if it is voluntary? The Hawaii Hurricane Relief Fund (HHRF) permits an opt-out for insurers. Many national insurers decided not to participate. Recently, State Farm filed to opt-out of the HHRF effective March 1, 1999. As a result, the purpose of the HHRF has come into question and the state may reevaluate its need.

The FHCF requires mandatory participation of all 292 insurers (except surplus line insurers) writing homeowners' and residential-type structures. Once established, several insurers unsuccessfully launched a constitutional challenge against mandatory participation and commercial property insurers successfully convinced the Legislature to exclude them from the FHCF. (However, the FHCF still provides for an emergency assessment on all lines of insurance except workers' compensation.)

While mandatory, the FHCF permits some choice through three levels of participation: 90 percent coverage, 75 percent coverage, and 45 percent coverage. Participation at the 90 percent level provides greater coverage to an insurer and results in higher reimbursement paid to the FHCF than the 45 percent level of participation. One hundred and forty insurers representing 86% of the hurricane exposure of the homeowners' insurance market selected the 90 percent level in 1996-1997. However, even in highly exposed Florida, 49% of all insurers representing 12% of total exposures selected the minimum level of participation in 1998-1999. Whether these insurers would participate in a voluntary fund is unclear. (It should be noted that the number of insurers participating in the Florida homeowners' insurance market is impacted by the moratorium on cancellation and nonrenewal which expires on June 1, 1999.) In any event, the need for insurers to participate in a state fund in New York is significantly less in New York because the severity and frequency of a hurricane is significantly less.

There is no guarantee that a catastrophe reinsurance state fund will provide stability after a mega-catastrophe. For example, the FHCF has no second event capacity. Once the mega-catastrophe drains the fund, it must begin at square one to rebuild. In the interim, problems will occur the day after the fund is depleted.

Primary insurers would be required to continue to pay reimbursement premiums to the FHCF (to help retire the fund debt) while the fund is unable to provide any coverage (all assets and debt capacity having been used). While continuing the mandatory premium payments, the primary insurers would be required to replace the FHCF coverage in the private reinsurance market. By relying too heavily on the fund, the industry may create conditions similar to the market instability after Hurricane Andrew.

insurance, by contrast, ensures either that some policyholders will pay rates that are too high or that insurance rates generally will be suppressed below the point at which insurers can earn a fair rate of return on the capital they place at risk to serve New York policyholders. Neither result is sound or fair; and neither result will contribute to making hurricane insurance more available in the state. The bedrock of any constructive reform to New York's insurance market must be that all policies shall carry actuarially sound rates.

As described above, the FHCF may levy a 2 percent to 4 percent emergency assessment on all lines of property and casualty insurance except workers' compensation. Obviously, this assessment provides a means of obtaining a subsidy from other lines of commercial insurance to cover homeowners' insurance losses. In Florida (based upon 1996 numbers), a 4 percent emergency assessment will annually raise \$32 million from liability insurance policyholders, \$29 million from commercial automobile liability policyholders, \$46 million from commercial multiple peril policyholders and roughly \$100 million from policyholders of other lines of commercial insurance.

Whether the FHCF is a solution with regard to mega-catastrophes remains untested. No one can guarantee that the market will be stable after a mega-catastrophe because of the existence of the FHCF. In fact, it is more likely that instability will exist because once the FHCF is exhausted, insurers will find themselves unprepared for the next hurricane and will have to seek reinsurance from the private market. However, unlike Hurricane Andrew, this instability occurs at the very same time that the FHCF makes an annual demand of \$440 million to rebuild the moneys in the FHCF.

The private market also is more efficient than a state fund in managing catastrophe exposures for all perils. A major winter storm could produce losses similar to a hurricane striking New York. Yet, retained earnings of the FHCF are used only to support coverages reinsured by the FHCF (New York residential property insurance in this instance) and cannot be used to support any other kind of insurance underwriting. Those funds in the private sector would be used to support insurance underwriting of other lines and in other states while supporting New York residential property insurance.

By creating dependence on a state fund, it may also produce negative behavior with regards to an insurer's underwriting practices. If an insurer's retention for catastrophe losses is negligible because of a state fund, it may diminish a property insurer's incentive to underwrite in a prudent and sound business fashion and thereby, place New York property insurance consumers at risk. Some insurers may over-concentrate their exposure or choose to accept risks without regard to insurability, cede almost all of the hurricane exposure to the reinsurance fund, and let the fund and industry as a whole bear the burden of insuring these risks. Because sound underwriting is the key to sustaining insurer solvency, such a practice increases the industry's risk and, ultimately diminishes availability by impairing the health of the industry.

Capacity of the pool, particularly in early years, is based on borrowing capability. Mandatory post-event participation is needed to collateralize repayment of that debt. Yet, the mandatory nature of the FHCF denies insurers writing in the state the right to make their own reinsurance decisions. Insurers that have followed prudent underwriting and managed their catastrophe exposure are rewarded with the additional cost of mandatory participation.

What if the state created a voluntary fund and no one joined? Or, in other words, would insurers have the need to participate in a state fund if it is voluntary? The Hawaii Hurricane Relief Fund (HHRF) permits an opt-out for insurers. Many national insurers decided not to participate. Recently, State Farm filed to opt-out of the HHRF effective March 1, 1999. As a result, the purpose of the HHRF has come into question and the state may reevaluate its need.

The FHCF requires mandatory participation of all 292 insurers (except surplus line insurers) writing homeowners' and residential-type structures. Once established, several insurers unsuccessfully launched a constitutional challenge against mandatory participation and commercial property insurers successfully convinced the Legislature to exclude them from the FHCF. (However, the FHCF still provides for an emergency assessment on all lines of insurance except workers' compensation.)

While mandatory, the FHCF permits some choice through three levels of participation: 90 percent coverage, 75 percent coverage, and 45 percent coverage. Participation at the 90 percent level provides greater coverage to an insurer and results in higher reimbursement paid to the FHCF than the 45 percent level of participation. One hundred and forty insurers representing 86% of the hurricane exposure of the homeowners' insurance market selected the 90 percent level in 1996-1997. However, even in highly exposed Florida, 49% of all insurers representing 12% of total exposures selected the minimum level of participation in 1998-1999. Whether these insurers would participate in a voluntary fund is unclear. (It should be noted that the number of insurers participating in the Florida homeowners' insurance market is impacted by the moratorium on cancellation and nonrenewal which expires on June 1, 1999.) In any event, the need for insurers to participate in a state fund in New York is significantly less in New York because the severity and frequency of a hurricane is significantly less.

There is no guarantee that a catastrophe reinsurance state fund will provide stability after a mega-catastrophe. For example, the FHCF has no second event capacity. Once the mega-catastrophe drains the fund, it must begin at square one to rebuild. In the interim, problems will occur the day after the fund is depleted.

Primary insurers would be required to continue to pay reimbursement premiums to the FHCF (to help retire the fund debt) while the fund is unable to provide any coverage (all assets and debt capacity having been used). While continuing the mandatory premium payments, the primary insurers would be required to replace the FHCF coverage in the private reinsurance market. By relying too heavily on the fund, the industry may create conditions similar to the market instability after Hurricane Andrew.

In addition, in the early years of the fund, insurers would lack confidence in the fund's ability to meet its obligations because of the limited amount of money collected by the fund. The fund would also be viewed as an untested entity. As a result, prudent insurers would still purchase duplicative reinsurance from the private market -- thus, insurers would pay twice for the same reinsurance coverage -- once to the state and once to the private market. In addition, FHCF prices are based on full coverage while the fund is able to cover only a limited amount of that coverage, particularly in the early years. Purchasing duplicative reinsurance and the levy of a new charge on insurers could produce disruption in the market.

In the early years, a fund would not immediately improve insurance availability. Advocates for a reinsurance fund contend that a fund would have a beneficial impact on the availability of homeowners' insurance. A fund would be financed by reimbursement premiums collected by insurers and these premiums would accumulate over a period of time. However, it would take a decade before the fund could be considered a "backstop" or have a beneficial impact on the behavior of insurers. In the interim, the fund would rely almost exclusively on a level of debt to pay bonds.

### **IX. Summary & Recommendations**

The Temporary Panel on Homeowners' Insurance concludes that homeowners' insurance in coastal communities is available and that a New York State insurance catastrophe fund is not needed. The number of homeowners' insurance policies written by the New York Property Insurance Underwriting Association (NYPIUA) has leveled off and the number of new NYPIUA policies is starting to decline. In the highest exposed area, NYPIUA has a coastal market share of only 1.9 percent in Nassau and Suffolk counties. In addition, policies written through the Coastal Market Assistance Plan (C-MAP) has been less than anticipated as evidenced by the fact that insurers have written only 2,900 out of the 5,000 policies under the commitment. These findings mirror the Panel's observations in 1998. It is expected that the coastal markets will continue to improve in 1999.

The Panel also concludes that the property and casualty insurance industry is better prepared to handle catastrophic events since Hurricane Andrew in 1992. The industry's surplus rose from \$193.1 billion in 1994 to \$342.0 billion in 1998. In addition to the strength of primary insurers, reinsurers are estimated to provide a minimum of \$7 to \$10 billion in reinsurance coverage in any one geographical area. There is an overabundance of capacity in the reinsurance market and catastrophe pricing is being driven down by the high level of excess capacity.

Supplementing the traditional reinsurance market is additional capacity from the capital markets. The capital markets funding of catastrophe natural exposures has grown from one transaction in 1994 totaling \$85 million to eighteen transactions in 1998 totaling over \$3 billion. This market is expected to continue to grow.

Based upon the review of these factors, the Panel concludes that the insurance industry is sufficiently positioned to absorb the impact of a major hurricane striking New York. The property and casualty industry has already handled multiple natural catastrophes producing insured losses between \$2 and \$18 billion. Based upon catastrophe computer modeling, the 1-in-100-year hurricane would produce estimated commercial and residential losses of \$3.9 billion in New York. Other models may produce a slightly higher or lower number for the 1-in-100-year event. This exposure is well within the industry's current capacity to absorb, and is significantly smaller than the \$35 billion in catastrophic losses handled by the industry from 1992 through 1994 when industry-wide surplus was only about 55% as large as it is today. Unlike California and Florida, which have established state catastrophe funds, New York does not experience the same severity and frequency of natural catastrophes.

Creation of a state catastrophe fund raises a number of public policy concerns. For example, a viable fund must be exempt from federal taxation and such an exemption requires significant state involvement and capital contribution from the state. Depending upon the structure of the fund, cross-subsidization could occur among lines of insurance such as policyholders in low-risk areas subsidizing high-risk areas, and commercial policyholders subsidizing homeowners' insurance policyholders. The use of taxes or post-event assessments on policyholders to finance revenue bonds for a catastrophe state fund camouflages the true cost of property insurance in New York, forcing low-risk homeowners to subsidize high-risk homeowners. Finally, creation of state catastrophe funds could retard the aggressive development of private market solutions that are being presently developed (*e.g.*, capital markets and other private market alternatives discussed in this Report).

In light of the ability of the property and casualty industry to handle a major hurricane striking New York and the possible disadvantages associated with a state catastrophe fund, the Panel, after much discussion and review, recommends against the creation of a state catastrophe fund in New York. Two members of the Panel did not concur in this conclusion.

## MARKET DYNAMICS SUBCOMMITTEE REPORT

### Members of the Market Dynamics Subcommittee

#### E. John Cucci

Joseph Calvo  
Michael Esermer  
Bill Goff  
Janet Glover  
Anthony Granito  
Benita Hirsch  
Floyd Holloway  
Doug Joseph  
Shelly Kozel  
Mark Kriss  
Tom Lutz  
Patricia Mann  
Bill Melchionni  
Charles Rapacciuolo  
Dan Robinson  
Michael Rosenzweig  
George Yates  
Anthony Yoder

#### Alliance of American Insurers, Chairman

New York Property Insurance Underwriting Association  
New York Property Insurance Underwriting Association  
Allstate Insurance Company  
New York Insurance Department  
Orion Specialty  
New York Insurance Department  
State Farm Insurance Company  
State Farm Insurance Company  
Lezok Ltd.  
Alliance of American Insurers  
Professional Insurance Agents of New York  
New York Insurance Department  
Nationwide Insurance Company  
New York Insurance Department  
New York Central Mutual Insurance Company  
Rosenzweig Financial Services  
Independent Insurance Agents of New York  
New York Insurance Department

### Market Dynamics Subcommittee Report

#### I. Purpose of the Subcommittee

The Market Dynamics Subcommittee of the Temporary Panel on Homeowners' Insurance was charged with conducting an analysis of homeowners' deductibles (disclosure and triggers), mitigation efforts to reduce loss, and the current state of capital markets in the funding of catastrophe exposures.

#### II. History and Current Status of Hurricane Deductible Programs in New York

In its 1996 report, the Temporary Panel on Homeowners' Insurance Coverage recommended that the Insurance Department should "approve appropriate large deductibles for hurricane damage." The report noted that "one of the most significant means of reducing probable maximum loss [PML] is the use of large deductibles applicable to catastrophe generated losses. By mandating that every policy contain such a deductible, a company will drastically reduce its insurable losses. The Panel strongly recommends that companies file and the Insurance Department approve appropriate large deductibles for hurricane damage." PML is the maximum dollar loss that an insurance entity would in all likelihood incur for a particular event.

The 1996 Panel predicted that this step would produce a market improvement in availability of homeowners' insurance. Since that time, the market availability for homeowners' insurance has indeed continued to improve. There are many reasons for this, and the leadership of the New York State Insurance Department in structuring and approving a program of hurricane deductibles has been a major factor in improved market availability.

This deductible program along with the Coastal Market Assistance Program and the continued re-authorization of New York's residual market mechanism (NYPIUA) have contributed greatly to the normalization of the market for Long Island consumers. Concerning NYPIUA, it was the unanimous opinion of the Panel that NYPIUA's legislative authority be made permanent in order for it to facilitate liquidity in the event of a catastrophe. The 1998 Panel made the same recommendation.

In general, policy deductibles are contract terms stating that an insurer's obligation to pay claims begins at a certain level of loss (the deductible amount). Claims that do not reach this amount, and damage costs below this amount (when the claim exceeds the deductible) are not paid by the insurer.

Traditional homeowners' contract deductibles have been expressed as relatively low dollar amounts (\$250, \$500 and \$1,000), applicable to all damage claims submitted under the policy. Policyholders generally have been offered a range of dollar-amount deductible options at various prices, with lower deductibles costing more.

In its Supplement to Circular Letter No.11 (1993), the Insurance Department finalized a set of guidelines for homeowners' insurers to use in filing for mandatory and optional deductibles applicable to claims for windstorm damage in coastal areas. The Department's guidelines provide for both "non-catastrophic" windstorm deductibles (applied whenever winds do not attain Category 2 hurricane status (i.e., sustained winds of 96 mph or more), as determined by the National Weather Service at landfall anywhere in New York State; and for "catastrophic" windstorm deductibles activated only in the event that Category 2 status or higher is experienced at landfall anywhere in New York State. The "non-catastrophic" guideline for a mandatory deductible is no more than \$500.

In addition, the Circular Letter Supplement noted that "an insurer may, with sufficient support, submit for Insurance Department consideration a windstorm deductible filing that differs from the articulated criteria."

As of December 18, 1998, thirty insurers (and two rate service organizations) have received approval for their windstorm deductible programs (see Appendix A). These programs provide for certain mandatory deductibles, ranging from one percent to five percent of Coverage A (dwelling amount of insurance), that apply under certain weather conditions and are applied to the peril of wind. Optional deductibles are available at higher percentages for a premium credit.

Company deductible programs vary considerably in the triggering events that activate these deductibles. Factors that affect the application of the deductible include sustained wind speed, the point of storm landfall, and declaration by the National Weather Service.

### **III. Areas of Agreement: Structure and Disclosure of Hurricane Deductibles**

While there was a difference of opinion on the Subcommittee concerning the flexible deductible program now in use as opposed to mandating standardized more uniform deductibles, the entire Subcommittee was in total agreement on the following:

- The deductible triggering event should be measured by: (1) maximum one-minute average sustained wind speed at a defined altitude within New York State; and (2) occurring within a named hurricane and not by storm surge or barometric pressure measurements.
- Insurers should offer policyholders an option of lower deductibles amounts if the policyholder undertakes significant mitigation efforts to protect the insured property.
- Insurers should be permitted to use computer modeling to support rate and deductible filings.
- Insurers should take steps to improve overall consumer understanding of all types of deductibles.
- Insurers that use deductibles for catastrophic management purposes should use specific hurricane deductibles in lieu of minimum all-peril deductibles.
- Full and adequate disclosure is vital to the success of the current deductible program, and Regulation 159 clearly spells out disclosure requirements. However, special efforts should be made by the Insurance Department during market conduct exams to specifically ascertain whether disclosure notices required by the Regulation were sent as required.
- When insurers notify insureds as to what deductibles are operative on their coverage, they should simultaneously notify producers so producers can also structure information and education programs for insureds.
- It is recommended that strong consideration be given by insurers to the use of a supplemental notice to facilitate consumer education. This notice can be general in nature and should remind policyholders that questions regarding deductibles or requests for additional information can be directed to their agent or company. The notice should be sent just prior to hurricane season.
- The Insurance Department should issue Public Service messages just prior to and throughout the hurricane season.



- Prior to and throughout the 1999 hurricane season, the Insurance Department should undertake a comprehensive public education campaign directed toward residents of areas where windstorm deductibles are in use.
- The Insurance Department should educate the public on the new opportunities for discounts for installation of hurricane-resistant glass and other mitigation steps available to them.

#### IV. The Argument for Standardized Deductibles

*Subcommittee members were divided as to whether the standardized or flexible deductible approach was the most suitable for the New York homeowners' insurance market. This section summarizes the major strengths of the standardized approach, while Section V makes the argument for flexible deductibles.*

All Subcommittee members are of the opinion that the use of deductibles assist carriers in managing their exposure in coastal markets; however, because of the diversity of triggering events and other variables, there is a concern among some members regarding the level of consumer understanding of deductibles and how they operate. A recent study conducted by the Independent Insurance Agents Association of New York indicated that 78 percent of Long Island homeowners surveyed did not know whether their policy had a windstorm deductible. (With the introduction of the mandatory disclosure form effective January 1, 1999, it is anticipated there will be increased consumer recognition of their true exposure.)

When asked how a windstorm deductible is calculated, nearly three-quarters (72 percent) did not know. Also, consumers were confused as to what deductible percentage would apply to their claims. Some respondents (14 percent) thought it was either a set amount or it was based on a percent of the claim, while another 14 percent correctly stated that the deductible amount is a percent of the insured value of their home. Of the homeowners surveyed, the majority (59 percent) did not know what triggered the deductible.

Critics of the present deductible program also point to recent Mississippi experience where coastal residents in that state filed a lawsuit challenging hurricane deductibles on homeowners' policies that insureds claim they did not understand until Hurricane Georges occurred. The courts have been petitioned to grant the case class-action status. In the interim, the Insurance Commissioner has asked insurers to voluntarily withdraw previously approved percentage wind deductibles (which were set at a standardized two percent) "due to the confusion, misunderstanding and severe hardship suffered by residents" affected by Hurricane Georges.

Accordingly, there were members who felt that deductibles should be standardized to avoid consumer confusion. In that vein, those Subcommittee members opting for standardization offered the following recommendations:

- In order to limit the frequency of triggering "CAT" deductibles, the minimum trigger should be 96-mph, one-minute sustained wind. If individual companies can demonstrate the need for additional deductible relief for storms of 74-to-95 mph, then they can be granted a higher flat deductible (perhaps \$1,000), as a means of managing frequency of claims in these Category 1 types of storms.
- "Stepped-Up" deductible filings which trigger higher percentage deductibles as sustained wind speeds increase could be one way of increasing participation of the property owner as the severity of the wind increases. This concept, according to its adherents, is one the public could easily grasp through an educational effort.
- As a standard practice, annual disclosure notices of hurricane deductible triggers and amounts should be provided to homeowners just prior to the hurricane season. The notices should be company-generated.
- The wind speed for hurricane deductible percentage triggers should not be the wind speed for a Category 1 hurricane. The Category 1 wind speed criterion is too low.

#### **V. The Argument for Flexible Deductibles**

There was equally strong sentiment expressed by other Subcommittee members that maximum flexibility be maintained in the current deductible program if a free and open market is to be maintained and to help encourage further growth of that market. Their feeling is that the Insurance Department's present program has in general created much needed opportunities within specific guidelines for insurers to increase market share in coastal areas of New York State. They point to the necessity for companies to establish individual underwriting guidelines, set rates that are adequate and not excessive in compliance with Insurance Department requirements, and determine marketing strategy while managing exposures and offering consumers viable choices. While this may result in some residents of the same area having different deductibles at the time of a catastrophic event, they ask the consumer to share only a manageable portion of the risk, while preserving product availability and affordability.

Moreover, they argue that promulgation and implementation of Regulation 159 should ameliorate the concern raised by some that the insured public is not aware that they have a hurricane deductible appreciably greater than the standard pre-Hurricane Andrew deductible, under what conditions the deductible is triggered, and to what property values it applies.

Additionally, it is the feeling of Subcommittee members who support the current flexible program as compared to a "one size fits all" approach that: the trigger for any hurricane deductible should be any named hurricane that strikes land in New York State. Percentage options (minimum of two percent) should be offered to customers allowing them to choose those options that suit their individual needs. This deductible would replace any specific dollar deductible for hurricane events only. Rules such as these

would allow companies to alter their positions depending on market and financial conditions.

Using a trigger above that of a Category 1 storm could cause market displacement as this may not mesh with a company's marketing or financial position. While larger fixed dollar, *e.g.*, \$1,000, hurricane deductibles will help, Probable Maximum Loss would likely be higher than insuring those risks with a two-percent deductible. For a company with significant coastal exposure, the PML could be as much as 35-40 percent higher. This would necessitate either a restriction in marketing or an increase in premium or both on the part of companies.

#### VI. Applied Insurance Research (AIR) Deductible Impact Study

To put the standard *v.* flexible deductible issues into perspective, the Subcommittee asked Applied Insurance Research (AIR) of Boston, Massachusetts, to conduct a study along the following lines:

(a) To estimate the industry's ground-up homeowners' losses (excluding losses from renters and condo policies and assuming no deductible) for Saffir-Simpson Category 1-5 hurricanes (separately in Suffolk, Nassau, Kings, and Queens Counties).

(b) To apply to the above estimates a two and three percent deductible (of Coverage A) and a flat \$1,000 deductible (all separately).

AIR agreed to do this research and furnish it to the Subcommittee at no charge. A complete copy of AIR's deductible impact study, entitled "Hurricane Loss Analysis - Homeowners" is attached as Appendix C.

In arriving at the estimated total insured property losses in accordance with (1) and (2) above, AIR used its proprietary database of numbers and values of residential properties by postal code. Please refer to Appendix A of the attached AIR study for a detailed description of AIR's proprietary database. For added clarification, the AIR loss estimates reflect hurricane losses resulting from both landfalling and non-landfalling hurricanes, do not reflect either storm surge or demand surge losses, and assume all properties are 100 percent insured to value.

Based solely upon the data contained in Exhibits I-IV of the attached AIR study, the following conclusions can be inferred:

(a) There *does not* appear to be an appreciable industry loss savings (as a percentage or straight dollar amount) associated with moving from a \$1,000 flat deductible to a two percent deductible proportional to the value of the home for Saffir-Simpson Category 1 and 2 hurricanes for the 50, 100 and 250 year return period storms in Kings, Queens, Nassau and Suffolk counties.

potential conflicts with other state agencies unless a more detailed comparison of the affected state regulations is performed and will most likely increase the cost of compliance for existing buildings.

The Subcommittee believes that the lack of an effective New York State performance-based building code needs to be addressed during the 1999 legislative session. While it is difficult to quantify dollar savings from such a code, nevertheless it remains a critical component in attaining loss mitigation in coastal New York.

Irrespective of the legislative outcome regarding BOCA, an effective mitigation strategy must include action that reduces expected losses for existing structures. Generally, adoption of stronger building codes and enforcement will only impact new construction. Consideration should be given to requiring replacement roofs to meet or exceed code performance criteria for new construction in instances where 50 percent or more of a roof covering undergoes replacement.

#### **B. Education**

The February 1, 1998, Panel Report emphasized the critical role consumer education plays in encouraging homeowners to take action in protecting their families and possessions from hurricane risk. As risk assessment modelling and other research provide increased information on the threat to individual structures and effective alternative mitigation actions, dissemination of the availability of such information is essential.

Education efforts should include public service announcements and the distribution of brochures currently available through entities such as FEMA and the Institute for Business and Home Safety. Public/private partnerships of organizations and governmental agencies coming together with a goal to support mitigation should be encouraged. Motivating people to address natural hazards requires a multi-faceted educational approach and is not a singular act. It is a process that can take months and years. Many voices must be involved – TV, radio, print media, videos, brochures, schools, etc. Children make excellent messengers and school-based educational awareness is a key component.

The creation of the mitigation demonstration center at SUNY Maritime College, Fort Schuyler in the Bronx, sponsored by numerous insurers, the Institute for Business and Home Safety, and others, together with the attendant publicity, has helped to raise public awareness of the natural disaster risk in New York. Ongoing public awareness activities at this location should be encouraged.

#### **C. Incentives for Mitigation**

The February 1, 1998, Panel Report noted that there is a need for a range of both public and private incentives to encourage homeowners (of existing homes) and

### VIII. Consumer Education Efforts

While the Subcommittee was divided on the issue of standardized deductibles *v.* a flexible deductible approach, there was unanimous agreement that prior to the 1999 hurricane season, the Insurance Department should undertake a comprehensive public education campaign directed towards residents of areas where windstorm deductibles are in use. Property owners would be encouraged to:

- Discuss their coverage with their insurance agent or company to determine whether their policy is subject to a windstorm deductible. In this respect, insurers, when notifying policyholders as to what deductibles are operative on their coverage, should simultaneously notify the agent. In this way, the agent will also be able to structure policyholder information and educational programs to supplement insurance company and Insurance Department efforts.
- Such discussions would focus on making sure the insured has a full understanding of the extent of their liability in the event of loss and determine whether the full extent of their liability is acceptable to them.
- If not acceptable, insureds should be made aware that alternatives such as "buy-backs" of the deductible are available.

Moreover, the Subcommittee was also united in their view that the Insurance Department should educate the public of the new opportunities for discounts for installation of hurricane resistant glass along with other mitigation steps they can take.

### IX. Mitigation

#### A. Building Codes

A critical recommendation of the Panel in 1998 was the adoption and enforcement of performance-based building codes and uniform building codes throughout coastal New York and New York State. Enforcement at a local level was also viewed as essential. During the 1998 legislative session, legislation was introduced to require New York State to adopt the BOCA National Building Code and related codes in place of current New York State Uniform Fire Prevention and Building Code. In lieu of adoption of BOCA, Chapter 131 of the Laws of 1998 was enacted into law requiring the Department of State to undertake a comparison study and report of the present New York Code and the BOCA codes.

The Code Comparison Study was completed in November of 1998 and concluded:

In summary, the project team believes that the BOCA National Fire Prevention Code will be easier to enforce, easier to administer, that it has the potential to promote economic development and it will increase public safety. Adoption of the BOCA National Fire Prevention Code will result in

builders and new home purchasers to retrofit or purchase homes that offer protection against hurricane risks.

The risk of loss or damage to property, including family pictures and other sentimental objects and possessions, is significantly greater in New York's coastal areas than commonly believed. Education of the risk together with the growing use of higher hurricane deductibles constitutes a significant means of fostering mitigation efforts. The relatively inexpensive cost of roof tie-downs and other retrofit techniques should be widely publicized, utilizing the educational channels noted earlier in the report.

Additional recommendations contained in the 1998 Panel Report include:

- Implementation of tax incentives for mitigation of loss. These should include exemption from real estate tax assessments on improvements and real estate tax reductions to reflect the value of mitigation, sales tax incentives for approved or certified retrofitting of existing homes, and income tax credits for purchasing or retrofitting existing homes.
- Requiring a certain wind-resistant performance standard before coverage would be available in the New York Property Insurance Underwriting Association remains a public incentive for mitigation that could be transferred to private sector insurance in terms of encouraging underwriting along the coast or underwriting with varying market deductibles or premium credits.
- An economic strategy should be put into effect by insurers to ensure that mitigation is a reasonable and economical choice for the coastal homeowner buyer or builder.

Finally, the State Insurance Department recently promulgated amendments to Regulation 57, providing for reduction in homeowners' rates, where hurricane/storm shutters or hurricane resistant laminated glass windows or doors have been installed. The availability of discounts will help encourage use of these mitigation techniques.

## **X. Capital Markets**

The 1998 Panel Report contained a detailed description of the recent trend toward securitization of insurance risk. Securitization has been established as an alternative source of protection for the insurance industry and is becoming more accepted as an asset class for the investment community. The 1998 Panel Report detailed the nature of this newly evolving market and the benefits it will afford the property and casualty insurance industry and the investment community.

The property and casualty industry's surplus base has grown from approximately \$260 billion at the end of 1996 to approximately \$300 billion at the end of 1997. Despite this growth, the industry faces the potential of a major catastrophic event estimated to have a probable maximum loss from a domestic catastrophe of approximately \$70 billion. An event of that magnitude could put the industry's surplus under severe strain wiping out

one-quarter of the total surplus from a single event. Capital markets as a new source of capital for the industry can dramatically temper this threat.

Due to the relatively small capital base supporting worldwide reinsurance risks, pricing for catastrophe coverage tends to rise dramatically after a large loss. The total value of the capital markets, however, is estimated to be \$13 trillion. Considering that the PML from a Florida or California catastrophe is approximately \$70 billion, it is likely that the capital markets would be relatively unaffected by an event of this magnitude.

As the number of investors participating in the insurance related capital market grows, issuers of insurance-related securities benefit by having a new and deeper pool of capital to assume risks. As catastrophe risk is spread over this larger capital base, the severe price increases that have traditionally occurred after a large event should be reduced significantly. Reduced volatility of reinsurance cost allows insurance companies to budget more accurately and to benefit from a more stable earnings stream.

The securitization of insurance risk continued its growth during 1998. A summary of press accounts detailing the growth of capital markets compiled by the Reinsurance Association of America is annexed to this report as Appendix B. Evidence suggests that CAT bonds retained liquidity during the turmoil in capital markets triggered by the volatility in Asia, Russia, and parts of South America, during 1998. (Source: Willis Faber Re- Market Review, December 1998.) The stability of CAT bonds during this time frame bolstered the claim that CAT bonds are not correlated to other financial instruments and can play an important role in balancing investment portfolios.

# Appendix A

## Homeowners' Insurance Deductible Filings

### New York State

(as of 1/31/99)

Company, File No., Approval Date	% Deductible based on Dwelling	Trigger (circumstances under which deductible is applicable)	Territory	Comments
American Association of Insurance Services (AAIS) R97005021 11/1/98	Optional, See Note A	The deductible is applicable when a windstorm loss occurs 12 hours before or 12 hours after a Category 2 hurricane, as determined by the National Weather Service, makes landfall anywhere in NYS.	See Note A.	This is a Rate Service Organization. This deductible may be used by member companies that adopt this filing.
Allstate R96002573 7/21/97	5%	The deductible is applicable to a windstorm loss that occurs during the following time period: a) beginning 24 hours prior to the time that a one minute average sustained wind speed exceeding 100 mile per hour at an altitude of 10 meters above any part of NYS during a hurricane, as estimated by the National Hurricane Center; b) during the duration of such hurricane; and c) ending 12 hours after the last time the National Hurricane Center declares that the hurricane has been downgraded to a tropical storm.	Staten Island, Bronx Queens, New York, Brooklyn, Nassau and Suffolk.	A 7% hurricane deductible is available on an optional basis to the insured.
Chubb	5% mandatory hurricane deductible to be applicable up to 1 mile on the North Shore of Nassau & Suffolk & up to 5 miles on the South Shore of Nassau and Suffolk. The remainder of Nassau & Suffolk will receive a 3% hurricane deductible.	Category 1 hurricane Trigger.	Nassau and Suffolk.	Hurricane deductible capped at \$50,000 The insured has the option of installing an approved windstorm protection in accordance with Chubb's guidelines, thereby eliminating this hurricane windstorm deductible.



Company, File No., Approval Date	% Deductible based on Dwelling	Trigger (circumstances under which deductible is applicable)	Territory	Comments
CIGNA Indemnity & Indemnity Co. of North America R97000645 3/1/97	3%	The hurricane deductible applies to windstorm loss that occurs within a period of 12 hours before or 12 hours after the storm which caused the loss makes landfall anywhere in NYS as declared the National Weather Service to be category 1,2,3,4 or 5 hurricane.	Nassau, Suffolk, Brooklyn, & Queens.	Have a \$1500 all wind deductible within 2500 ft. from the affected areas. <i>Approved on an experimental basis.</i>
CIGNA - applicable to the rest of the companies other than those approved for the Special Long Island Program R97004459 1/16/98	3%	category 1 or higher hurricane	applicable within 2500 feet of an ocean, sound, bay or similar body of water in the following counties: Nassau and Suffolk Kings, Queens, Richmond, Westchester and Bronx	Optional 5% hurricane deductible is available. Currently Cigna has on file with the Dept., a Special LI Program which provides for: a mandatory 3% hurricane deductible to be applicable in LI, Brooklyn and Queens; a \$1500 all wind deductible to be applicable with in 2500 feet from the shore and an optional 5% hurricane. The Special LI Program is approved for only 2 of Cigna's companies: Indemnity Insurance Company Of North America and Cigna Indemnity Insurance Company
Clarendon R98003085 9/15/98	Optional hurricane deductibles, ranging from 2%, 5% & 10%.	Trigger is a category 2 hurricane, making landfall in NYS.	Available only for the coastal areas	Disclosure notices comply with Reg. 158.

Company, File No., Approval Date	% Deductible based on Dwelling	Trigger (circumstances under which deductible is applicable)	Territory	Comments
CNA Companies R96002456, 7, and 8 3/15/97	5% for risks located 1 mile or less from the shore; 2% for risk located more than 1 mile but less than 5 miles from the shore; 1% for risks located more than 5 miles from the shore within the entire coastal area.	Category 1 or higher hurricane as designated by the National Weather Service, at the time it impacts anywhere in New York.	Brooklyn, Queens, Westchester , Nassau, Suffolk, Bronx, Richmond, & New York counties.	Higher hurricane deductibles may be elected on an optional basis.
Colonial Penn R94002511 & R94002536 1/30/95	See Note A.	The deductible is applicable to a windstorm loss if, according to the National Weather Service, a Category 2, 3, 4 or 5 hurricane makes landfall anywhere in New York State within 12 hours before or 12 hours after windstorm loss.	See Note A.	
Commercial Union R96002138 07/31/96	See Note A.	The deductible is applicable to a windstorm loss if, according to the National Weather Service, a Category 2, 3, 4 or 5 hurricane makes landfall anywhere in New York State within 12 hours before or 12 hours after windstorm loss.	See Note A.	
Fireman's Fund	2% or 1%.	The deductible applies to losses which occur as a result of either: a) a Category 1 or higher hurricane making landfall in NYS, or b) a hurricane making landfall outside of NYS, but which is determined by the National Weather Service to be a Category 1 or higher hurricane force winds in the area within NYS in which the losses occur.	Mandatory 2% for Nassau and Suffolk. Mandatory 1% for St. Queens, & Brooklyn.	Optional 2% 5% and 10% hurricane deductibles are available.

Company, File No., Approval Date	% Deductible based on Dwelling	Trigger (circumstances under which deductible is applicable)	Territory	Comments
General Accident R94003043 1/18/95	See note A.	The deductible is applicable to windstorm loss to covered property, that occurs within a period of 12 hours before or 12 hours after the storm which caused the loss makes landfall anywhere in New York State as declared to be a Category 2, 3, 4 or 5 hurricane by the National Weather Service.	See Note A.	
Hartford R97000014 03/97	5%.	The hurricane deductible applies to windstorm loss that occurs within a period of 12 hours before or 12 hours after the storm which caused the loss makes landfall anywhere in NYS as declared by the National Weather Service to be a category 1,2,3,4 or 5 hurricane.	Entire coastal area (Note A) except for the Bronx and Westchester Counties.	Renewal business will have the option to buy back to the expiring current policy deductible.
Insurance Services Organization (ISO)	Optional, See Note A	The deductible is applicable when a windstorm loss occurs 12 hours before or 12 hours after a Category 2 hurricane, as determined by the National Weather Service, makes landfall anywhere in NYS.	See Note A.	This is a Rate Service Organization. This deductible may be used by member companies who adopt this filing.
Lancer R93004181 12/28/93	See Note A.	The deductible shall be activated only in the event a Category 2 Storm, as defined by the National Weather Service, makes landfall within the geographic boundaries of the State of New York and shall apply only to losses as a result of that storm for damage and loss covered under the peril of windstorm.	See Note A.	
Merchants Mutual R94001257 6/1/94	Adopted ISO's deductible with the exception of a mandatory \$500 windstorm deductible for the affected areas.	Does not have a mandatory hurricane deductible, however, has a mandatory \$500 all wind deductible.	Kings, Queens, LI, SI, Westchester, and Bronx.	\$2000 mandatory standard windstorm deductible applicable to C-Map policies only. Company has not implemented ISO's filing.

Company, File No., Approval Date	% Deductible based on Dwelling	Trigger (circumstances under which deductible is applicable)	Territory	Comments
Metropolitan Property & Casualty R96004067 12/31/96	The policy deductible is mandatory and an optional 2% and 5% Hurricane deductible is available.	The deductible is applicable to a loss caused by a hurricane windstorm. A hurricane windstorm means a windstorm and accompanying winds along its path, which is identified and recorded as a hurricane by the National Hurricane Center or any agency responsible for identifying and recording hurricanes.	SI, Queens, Bronx, Brooklyn, Nassau, and Suffolk.	Base premium for the affected territories does not include hurricane windstorm coverage. It must be added for a charge. The surcharge factors vary depending upon the territory and the amount of the deductible. The policy deductible is mandatory and an optional 2% and 5% Hurricane deductible is available.
National General R95000785 1/17/96	1%	The deductible is applicable to a windstorm loss that occurs within a period of 12 hours before or 12 hours after the storm, which caused the loss, makes landfall anywhere in New York State as declared Category 2, 3, 4 or 5 hurricane by the National Weather Service.	LI South Shore, Bklyn, Queens, SI, and LI Forks.	
Nationwide R96002213 10/4/96	2%	The deductible applies in the event of a loss caused by any one storm declared to be a hurricane by the National Hurricane Center/Tropical Prediction Center; and makes landfall in NYS or contiguous states; and causes loss in NYS while it is a hurricane or throughout any subsequent downgrades in storm status by the National Hurricane Center/Tropical Prediction Center, until it is no longer a tropical storm.	Bronx, Kings, NY, Queens, Richmond, Westchester, Suffolk, & Nassau Counties.	Higher hurricane deductibles may be elected on an optional basis.

Company, File No., Approval Date	% Deductible based on Dwelling	Trigger (Circumstances under which deductible is applicable)	Territory	Comments
NY Casualty	1%	The hurricane deductible applies to windstorm loss that occurs within a period of 12 hours before or 12 hours after the storm which caused the loss makes landfall anywhere in NYS as declared by the National Weather Service to be a category 1,2,3,4 or 5 hurricane.	Kings, Queens, Richmond, Suffolk, & Nassau Counties	
NY Central Mutual R97004079 7/21/98	3% & 5%	The deductible applies to windstorm loss that occurs within a period of 12 hours before or 12 hours after the storm which caused the loss makes landfall anywhere in NYS as declared by the National Weather Service to be a Category 2, 3, 4, or 5 hurricane	Bronx, Kings, Queens, Richmond, Suffolk, & Nassau Counties	<p>The 3% mandatory hurricane deductible would be applicable in the event of a category 2 or 3 hurricane makes landfall in NYS and the 5% mandatory hurricane deductible would be applicable in the event of a category 4 or 5 hurricane makes landfall in NYS.</p> <p>It should be noted that only 1 of the hurricane deductible would be applicable, depending upon the category of hurricane that makes landfall in NYS, e.g. if a category 2 hurricane makes landfall then only the 3% deductible would be applicable and if a category 4 hurricane makes landfall then only the 5% deductible would be applicable</p>

Company File No. Approval Date	% Deductible based on Dwelling	Trigger (circumstances under which deductible is applicable)	Territory	Comments
Business No. 15437	25	The hurricane deductible applies to windstorm loss that occurs within a period of 12 hours before or 12 hours after the storm which caused the loss makes landfall anywhere in NYS as declared by the National Weather Service to be a category 1, 2, 3, 4 or 5 hurricane.	State of Island, Queens, Bronx, Brooklyn, Westchester, Nassau and Suffolk.	
Plan No. 10 11-45-1-10-11 1000000000 1-1-1	15	The deductible applies to windstorm loss that occurs within a period of 12 hours before or 12 hours after the storm which caused the loss makes landfall anywhere in NYS as declared by the National Weather Service to be a category 1, 2, 3, 4 or 5 hurricane.	See Note 4.	
10-10-10 10-10-10 10-10-10 1-1-1	25	The deductible is applicable to a windstorm loss caused by winds in New York State at least a Category 2 hurricane as classified by the National Weather Service.	See Note 4.	25% windstorm deductible with the option of buying back to the regular policy deductible.
10-10-10 10-10-10 10-10-10 1-1-1	25	Category 1 Hurricane Trigger not applicable.	See Note 4.	For the remaining 25% deductible, see 10-10-10.
10-10-10 10-10-10 10-10-10 1-1-1	25	The deductible applies to windstorm loss that occurs within a period of 12 hours before or 12 hours after the storm which caused the loss makes landfall anywhere in NYS as declared by the National Weather Service to be a category 2 hurricane or higher.	See Note 4.	The deductible is 25% of the loss.

Company, File No., Approval Date	% Deductible based on Dwelling	Trigger (Circumstances under which deductible is applicable)	Territory	Comments
TIG R97003949 R97003973 R97003949 6/10/98	5% mandatory deductible one mile in the coastal areas and 2% mandatory deductible further inland.	The deductible applies to losses which occur as a result of either: a) a Category 1 or higher hurricane making landfall in NYS, or b) a hurricane making landfall outside of NYS, but which is determined by the National Weather Service to be a Category 1 or higher hurricane force winds in the area within NYS in which the losses occur.	5 NYC boroughs, and Long Island.	Optional higher hurricane deductible available.
Travelers Companies R96004580 & R96004386 12/13/96	5% hurricane deductible applicable up to one mile from LI, South Shore & the shores of Brooklyn, Queens, SI, & Long Island Forks and up to 1000 feet from Long Island North Shore, the areas along the Bronx and Westchester County along the Long Island Sound. 3% hurricane for the remainder of Long Island and the 5 boroughs.	The deductible applies to losses which occur as a result of either: a) a Category 1 or higher hurricane making landfall in NYS, or b) a hurricane making landfall outside of NYS, but which is determined by the National Weather Service to be a Category 1 or higher hurricane force winds in the area within NYS in which the losses occur.	See Note A.	Insureds with the 3% mandatory hurricane deductible have the option to purchase a 4% or 5% hurricane deductible.
Tristate R97003789 5/15/98	2%	The deductible applies to losses which occur as a result of either: a) a Category 1 or higher hurricane making landfall in NYS, or b) a hurricane making landfall outside of NYS, but which is determined by the National Weather Service to be a Category 1 or higher hurricane force winds in the area within NYS in which the losses occur.	5 NYC boroughs, Westchester , and Long Island	

Company, File No., Approval Date	% Deductible based on Dwelling	Trigger (circumstances under which deductible is applicable)	Territory	Comments
Underwriters Rating Board	See Note A			A rate service organization
USF&G R97001285 10/15/97	2%	The hurricane deductible applies to windstorm loss that occurs within a period of 12 hours before or 12 hours after the storm which caused the loss makes landfall anywhere in NYS as declared by the National Weather Service to be a category 1,2,3,4 or 5 hurricane.	Staten Island, Queens, Bronx, Brooklyn, Nassau and Suffolk.	
Utica First R97000239 & R97000247 7/15/97	1%	The deductible is applicable when a windstorm loss occurs 12 hours before or 12 hours after a Category 2 hurricane, as determined by the National Weather Service, makes landfall anywhere in NYS.	Queens, Nassau & Suffolk Counties.	
Utica Mutual	OPTIONAL – SEE COMMENTS	Category 1 Hurricane.	NYC & LI	Optional (all wind) deductible for the entire state. Available % deductible option of 1%, 2%, or 5% of coverage A & fixed dollar amount of \$1000, \$2000, & \$5000.
Worcester R97001510 6/5/97	2%	The deductible is applicable to a windstorm loss if, according to the National Weather Service, a Category 1, 2, 3, 4 or 5 hurricane makes landfall anywhere in New York State within 12 hours before or 12 hours after windstorm loss to covered property first occurs.	Bronx, Brooklyn, LI, Queens, and SI.	
<b>Note A:</b> See guidelines contained in Circular Letter No. 11 (1993), which was issued to all insurers writing homeowners' policies informing them of standards to be followed in making filings for windstorm deductibles. <b>Source:</b> New York State Insurance Department				



## Appendix B

**Tapping the Capital Markets, Securitizing Insurance Risk**  
**Summaries of articles from the insurance and business press on the growth of**  
**capital markets as an alternative to traditional reinsurance for catastrophic risks**  
*(Compiled by the Reinsurance Association of America)*

### January 1998

*Business Insurance* reported that purchasers of a watershed catastrophe bond deal, sold in June of 1997, will realize large returns. This is good news for the cat bond market and will have a positive effect for investors in 1998. According to Richard L. Sandor, chairman of Hedge Financial Products Inc. in Chicago, "[t]he risk securitization market is in maturation." Signs of the maturation are: new cat bonds, more investment banks entering to underwrite the issues, and new players in insurance derivatives. Mr. Sandor noted that the market is "seeing a resounding growth in (the risk of securitization) market, and we are also seeing a set of investors that have done well." He expects this pattern to continue in 1998. *Business Insurance* January 5, 1998.

The Chicago Board of Trade (CBOT) expects to receive authorization to launch insurance option contracts which will cover individual catastrophes rather than aggregate insurance losses. "Traders will be able to buy and sell contracts covering earthquakes, atmospheric events, and all perils." These contracts will cover nine regions: national USA, northeast, east, southeast, midwest, west, California, Texas, and Florida. *Reinsurance Market Update Report 5*, January 7, 1998.

According to a *Business Week* article some \$900 million worth of CAT bonds have been sold in the last 13 months. Analysts expect \$2 billion to \$5 billion in new catastrophe bonds to be issued in 1998. *Business Week*, January 26, 1998.

### February 1998

"First Boston, Goldman Sachs & Co., Merrill Lynch & Co., Morgan Stanley Dean Witter, and Salomon Smith Barney have deployed teams of investment bankers and traders to develop the cat bond market." The teams are being assisted by statisticians, meteorologists and geologists who are responsible for assessing the risks attributed to earthquakes, hurricanes, and other natural disasters. According to Jon Barry, investment banker at Salomon Smith Barney, cat bonds are becoming a core source of profitability for many of the major investment banks. Mr. Barry predicts that within five years, issues of cat bonds will reach between \$50 to \$100 billion. *New York Business*, February 16, 1998.

**March 1998**

Over the past few years, the Chicago Board of Trade, the Catastrophe Risk Exchange and the Bermuda Commodities Exchange have developed new risk trading facilities. However, Steve Bolland, senior vice president of Gill & Roeser, stated that although the new facilities are "worthwhile and have a very valid position in the marketplace, at the moment there is little need for them." The new facilities were created at a time when the market was tight, but now prices are down. Thus, the best place to obtain reinsurance is through the traditional markets because rates are down, there is much flexibility and there is a better system of accounting. *National Underwriter*, March 9, 1998.

A proposed amendment to Bermuda's Insurance Act of 1978 may set the future standards for the securitization of insurance risk. According to Thomas C. Heise, president of the Pembroke, a Bermuda-based insurance risk market, "the Insurance Amendment of 1998 would allow for the formation of special-purpose vehicles designed to sell insurance-linked derivatives, such as catastrophe bonds." *National Underwriter*, March 9, 1998.

"Centre Solutions Ltd. has attained retrocessional capacity against Florida hurricanes through an \$83.6 million securitization led by Goldman Sachs." This is the first deal of 1998 which bypasses the reinsurance market and turns to the wider capital markets to provide catastrophe protection. USAA is expected to make a \$477 million deal later in the year. According to Richard Trimbrell, head of Centre Risk Advisors, "the cat bond will help Centre Solutions offer long-term stability to its customers in the event of a capacity crunch and price increase after a large loss." *National Underwriter*, March 16, 1998; *Business Insurance*, March 16, 1998.

The *Business Insurance* reports that many companies with large catastrophe exposures forego seeking coverage in the traditional markets because the companies are unable to obtain the limits they need. According to Morton N. Lane, president of Sedgwick Lane Financial L.L.C. in Chicago, the capital markets are becoming quite attractive and predicts that there will be a move into these markets within the next 12 months. *Business Insurance*, March 16, 1998.

According to a risk management consultant, "[p]roducer-driven risk financial vehicles covering the risks of small, 'Main Street' accounts, represent the largest potential source of growth for the alternative market." Policies under \$25 million a year in premiums are an untapped source of business for the alternative market. Michael Murphy, president of Risk Cap, a Denver Colorado based risk management firm, noted that the alternative market is composed of "small markets and smaller middle-market commercial insureds with identical or similar risks who have been grouped together in large blocks of premium volume in order to create profit opportunities for the owners of the books of business." *National Underwriter*, March 23, 1998.

**April 1998**

*Reactions* reported that "the death of the cat bond has been greatly exaggerated. Neither the traditionalists' skepticism nor a persistently soft market have dampened issuers' enthusiasm." Also, it was reported that there are new initiatives by banks and insurers to form dedicated units to sell catastrophe insurance bonds. *Reactions*, April 1998.

According to Tal P. Piccione, chair and chief executive officer of US Re Companies, "traditional reinsurance is becoming in many respects a commodity market as competition is focused increasingly on price. Reinsurance professionals also are keenly aware that more than a third of all commercial property premium in the United States is flowing to the alternative insurance market." *National Underwriter*, April 6, 1998.

*Best Review* reported that the insurance backed investment, known as risk securitization, may be booming in the foreseeable future. "A flurry of important transactions occurred in 1997, and investment bankers say to expect more in the coming quarter. Ten or more deals are expected this year." The 1997 transactions each targeted different investor groups and showed new possibilities for securitized insurance risk. The participants in the 1997 deals stated that given the existence of a soft market for reinsurance, the selling of risks through bonds did not save them any money. However, for some insurers securitizing will build a track record that can be used for leverage if coverage becomes difficult to obtain. *Yahoo Finance Business Wire*, April 10, 1998.

Mitsui Marine & Fire Insurance Co. Ltd. has received \$30 million in earthquake reinsurance coverage backed by an "event-linked swap transaction" arranged by Swiss Re Capital Markets. The swap transaction involves the exchange of premium flows from Swiss Re to institutional investors, unlike securitized transactions which generally involve capitalizing a special purpose vehicle or insurer through the issuance of securities. *National Underwriter*, April 20, 1998.

American International Group, Inc. (AIG) has announced that AIG Risk Finance, a division of AIG, will be offering a new risk financing program that will "help companies minimize the negative earnings per share impact of weather related events." The program is entitled Snow, Temperature, and Rain Management (STORM). STORM is a program that combines adverse weather results with economic losses. "STORM programs are targeted to companies with seasonal earnings/revenues or fixed or seasonable expenditures subject to weather related events; companies with an attendance-driven revenue base affected by adverse weather; or companies with fixed seasonal budgets and expenditures." *American International Group, Inc. Press Release*, April 27, 1998.

**May 1998**

According to Duff & Phelps Credit Rating Co. (DCR), the catastrophe market is due for an expansion in the next few years which should amount to multi billion annual issuances by the turn of the century. DCR has noted increased acceptance of cat bonds by both insurers and investors as evidenced by the \$1.4 billion in cat bonds issues in recent years. *Yahoo Finance PR Newswire*, May 5, 1998.

The *National Underwriter* reported that 1997 was a tremendous year for the insurance securitization market due to the capital markets' acceptance of over \$1 billion of insurance risk. "Several key cat bond transactions, including those by USAA, Swiss Re, Winterthur and Tokio Marine, have opened the door to future capital market activity, and new securitization deals are now in progress." *National Underwriter*, May 1998.

**June 1998**

Swiss Reinsurance Co., Zurich, Switzerland, has completed two major capital market transactions. The first involved a private placement on the European market of 1,010 million Swiss francs (\$1 = 1.472) in a so-called hybrid capital deal. The second transaction was undertaken by Swiss Re Finance which "floated a 1.25% exchangeable bond issue of 925 Dutch guilders (\$1 = 1.991), with a five year term. *Best Week*, June 1, 1998.

Goldman Sachs has set up a reinsurer, Arrow Re, located in Bermuda which will act as an interface between insurance and reinsurance clients and the capital markets. Goldman will place all the risks it possesses in the capital markets. "Arrow Re is designed to bridge the gap in demand which exists between capital markets' investors' growing appetite for insurance risk and the number of securitised transactions being done." The new company plans on conducting its business by using a reinsurance contract in order to maintain the same form and process as the traditional market, but it will also access the capital markets to offset these risks. *Reactions*, June 1998.

Reliance National purchased an option to cover itself against any potential increases in reinsurance rates in the event of a series of catastrophes. The option was issued by Sedgwick Lane Financial and is the first of its kind in the insurance industry. The option allows Reliance to buy reinsurance coverage, at a fixed price, if the rates go up as a result of several large losses. However, if the rates soften then Reliance can forego the option and buy coverage from the traditional market. The classes of risk covered by the option are: US property, property in the rest of the world, aviation, marine drilling rigs and satellite launch failure. *Reactions*, June 1998.

Chubb Insurance Co. of Europe, announced a new unit to service alternative risk programs for European clients. The company has formed an alliance with the accounting firm of Ernst & Young, whose consultants will provide integrated risk assessment and Chubb will set up a specialist reinsurance company to assist in providing alternate risk programs. *Business Insurance* June 15, 1998.

According to John Nichols, managing director of risk finance for AIG Europe (UK) Ltd., the capital markets will be used regularly in a complimentary role to the traditional markets, rather than replacing them. The capital markets will be used to hedge against catastrophe exposures and Mr. Nichols predicts that the use of these markets will grow in the future. He notes that capital markets will play a role in the market because potential losses from catastrophe risks in the United States and globally far exceeds the insurance industry coverage currently available. *Business Insurance*, June 15, 1998.

Lehman Brothers Holding Inc. has created a reinsurance subsidiary with \$500 million in capital in the Bermudian market. The subsidiary, Lehman Re Ltd., will channel insurance and reinsurance risks to the capital markets through securitization or structured derivative products. Lehman Re will initially cover finite risk and other financial coverages; property catastrophe reinsurance; political risk and trade credit reinsurance; and life reinsurance. Most of Lehman's business will be handled through agents and will offer coverage in the traditional manner. According to Michael Gelband, the reinsurance unit's president, Lehman Re will be at the forefront of the convergence of the insurance and capital market. *Business Insurance*, June 22, 1998; *The National Underwriter*, June 22, 1998.

United Services Automobile Association has acquired \$450 million in catastrophe reinsurance from Residential Reinsurance Ltd., Cayman Islands. The transaction was funded by hurricane-linked bonds with a life of 11 ½ months that will pay an annualized yield of 400 basis points. *Best Week*, June 22, 1998.

Yasuda Fire & Marine Insurance Co. Ltd., a Japanese domiciliary, secured \$80 million in reinsurance for typhoon exposures from Pacific Re Ltd, a Cayman Islands domiciled special purpose vehicle. The notes were arranged and brought to the market by Aon Capital Markets Inc., a subsidiary of Aon Corporation. *Business Insurance*, June 29, 1998.

#### **July 1998**

American Re Corporation announced the formation of American Re Capital Markets Inc. which will work in conjunction with American Re-Insurance Co. This new entity will provide its customers with integrated solutions for mitigating risks in the financial markets and be a leading provider of alternative risk management solutions. Initially, American Re Capital Markets will focus on the weather derivatives market, protecting both buyers and sellers of weather-dependent products and services against significant fluctuations in weather conditions. *The Journal of Commerce*, July 27, 1998.

Enron Corp. is in the process of creating an "over-the-counter trading market in weather risk management." This would allow corporations and individual speculators to make calculated predictions on the weather. For example, a company whose business is dependent on a hot summer could hedge with a bet on a mild summer. *Swiss Re America: Marketing Notes*, July 1998.

**August 1998**

AXA and Paribas, a French Bank, have structured a catastrophe option to cover the Californian earthquake risks of an unidentified US insurer. According to Marc Romano, chairman of the AXA/Paribas joint venture, the amount of the option is estimated at around \$50 million. *Reactions*, August 1998.

Zurich Group and Swiss Re have entered into an insurance transaction that will provide \$800 million of environmental liability overage to Hanson plc, a London-based international building materials company. The transaction provides coverage on 200 sites in the United States of the former Koppers Co. operations of Beazer plc relating to environmental and roof product liabilities. This transaction will lower the cost of transferring the funding of environmental liabilities from \$275 million to \$155 million. *Best Week*, August 10, 1998.

Swiss Reinsurance Co. has created a basis swap with a New York reinsurance company for US windstorm damage. The transaction involves the use of capital market techniques, but not the capital markets themselves. According to Gall Belonsky, director of Swiss Re New Markets in New York, the swap offers the reinsurer a lower premium than a standard catastrophe reinsurance program. "In this deal Swiss Re looks to the New York reinsurer for payment if industry losses exceed their trigger, but in the future Swiss Re could also look to other reinsurers or to the capital markets." *Business Insurance*, August 31, 1998.

**September 1998**

The *Journal of Commerce* reports that the F&G Re's completed deal with Goldman Sachs and E.W. Blanch Capital Markets will benefit Mosaic Re, an offshore firm that provides reinsurance on F&G Re's products. The deal is a single tranche, popular - at - risk deal similar to USAA's June 15 deal. The cat bond will protect Ft and Re from U.S. earthquake and hurricane losses of \$20-75 million. *Journal of Commerce*, September 4, 1998.

**December 1998**

CNA has issued \$200 million of 6.6 percent notes due December 2008. Goldman Sachs is the lead manager, and Lehman Brothers the co-manager for the issue. The net proceeds will be used for general corporate purposes. (1998)

## **Appendix C**

**Appendix C is a report, "Hurricane Loss Analysis-Homeowners," prepared by Applied Insurance Research. The report, which runs from page 77 through page 92, is available from our Studies and Reports Page. Appendix C is also available in the hard-copy version which can be obtained through the Department's Publications Unit (1-800-342-3736).**

Completed Transactions	Risk Capital (in millions)	Type of Cedent	Type of Coverage	Underlying Risks
Hedge Financial Risk Transfer Swap/Bond	90	Reinsurer	Index Swap/Bond	Northeast US Hurricane
Mitsui Risk Transfer Option	30	Primary Insurer	Parametric Option	Japanese Earthquake
Trinity Re(Centre Solutions)	72	Primary Insurer/ Reinsurer	Indemnity Reset	Florida Hurricane
<b>1997</b>				
SLF II (Reliance National)	10 est.	Primary Insurer	Indemnity	U.S. Property, Other Property, Marine, Aviation, Satellite
ASLAC Funding Trust II-IV	158	Primary Insurer	Indemnity	Life (Variable Annuity)
Parametric Re(Tokio Marine & Fire)	90	Primary Insurer	Parametric	Japanese Earthquake
SR Earthquake (Swiss Re)	112	Reinsurer	Index	California Earthquake
Residential Re I Risk Transfer Swap	35	Reinsurer	Index Swap	East and Gulf Coast Hurricane
Residential Re I(USAA)	400	Primary Insurer	Indemnity	East and Gulf Coast Hurricane
SLF I (Reliance National)	10 (est.)	Primary Insurer	Indemnity	US Property, Other Property, Marine, Aviation, Satellite
<b>1996</b>				
Winterthur	6	Primary Insurer	Index	Swiss Automobile Hail
AKG Combined Risk	10	Primary Insurer	Index	Global
K2 (Hannover Re)	100	Reinsurer	Indemnity	Global Property Catastrophe
George Town Re (St. Paul Re)	45	Reinsurer	Indemnity	US Property, European Property, Other Property, Lloyd's Retro, Marine and Aviation
ASLAC Funding Trust I	42	Primary Insurer	Indemnity	Life (Variable Annuity)
<b>1994</b>				
Kover (Hannover Re)	85	Reinsurer	Indemnity	Worldwide Property Catastrophe, excluding US, Japan



July 30, 1999

**STATEMENT OF REP. RICK LAZIO (R-NY),  
CHAIRMAN, SUBCOMMITTEE ON HOUSING AND  
COMMUNITY OPPORTUNITY**

---

Thank you, Mr. Chairman. And again, thank you for holding today's hearing and for your leadership on this critical issue.

I must congratulate the Chairman for putting together the balanced presentation we will hear today. It is clear that all sides in this debate are being provided a fair opportunity for discourse, and I will continue to support this sort of open dialogue.

Mr. Chairman, the time to deal with the issue of available and affordable homeowners' insurance in disaster-prone areas is now. Congress has been debating the merits of proposals designed to address homeowners' insurance availability for much of this decade. Our Committee has spent considerable time examining the issue over the last three years. Last year, we reported out legislation identical to the bill before us today with strong support from both sides of the aisle.

In the simplest terms, our efforts today are about providing greater opportunities for families across America to protect their own homes. Many of us here take the ability to insure our homes for granted. But it is not so easy for working families in Missouri, North Carolina,

Texas and other states, not to mention California and Florida. For them, the forecasts of more frequent and more forceful storms over the next few decades only bring uncertainty and fear of the future.

Its about people like 87 year-old Mildred O'Shaughnessy whose home of 51 years was destroyed just last year when Hurricane Georges hit Louisiana. Mrs. O'Shaughnessy had been unable to find insurance to protect her home. So now, she is forced to rely on her family and donations from the community for shelter and the necessities of life.

Some states have been able to rebuild in the aftermath of natural disasters from the early 1990s. But for the most part, that ability has been simply a matter of luck. Devastated by \$16 billion in insured losses from Hurricane Andrew in 1992, the property insurance market in Florida collapsed. Since then, Florida has been somewhat successful in encouraging the re-expansion of the private market, and today can absorb \$11 billion in insured residential losses. But that success has only been possible for one reason—Mother Nature has spared Florida a major disaster during that time.

Other Committees have already acted this Congress to address issues associated with the rising costs of natural disasters. In March, the House passed two separate bills designed to address the issue of disaster mitigation.

The first bill, the “Disaster Mitigation Coordination Act,” sponsored by Rep. Talent and two Members of this Committee, Ms. Velazquez and Ms. Schakowsky, will provide \$75 million over the next five years to establish a program for making loans to small businesses to implement disaster mitigation measures.

The second bill, the “Disaster Mitigation and Cost Reduction Act,” sponsored by Rep. Fowler and two other Members of this Committee, Mr. Terry and Mr. Sweeney, will provide over \$100 million in grants to States and local governments for predisaster mitigation activities.

So clearly, the House has recognized the importance of mitigation efforts in preparing for natural disasters. And as is appropriate, it is an issue being dealt with by the Committees of relevant jurisdiction.

Our proposal creates an environment where the private market is encouraged to re-engage in the business of homeowners’ insurance across the country. In Subcommittee hearings this Congress, we have heard testimony that a more stable and confident private insurance market in vulnerable areas of the country would benefit all Americans. It is probably true that those living in North Dakota, Montana and other similar states would be less affected by our proposal. But that is no reason why my constituents in the state of New York, or the

constituents in the districts of other Members of this Committee should be denied the opportunity to protect their families and homes.

Since 1983, taxpayers have spent more than \$80 billion in Federal dollars for disaster relief. And it is true that population growth and coastal development play a part in the rising costs of natural disasters. But it is also true that within the next 10 years, according to the U.S. Census Bureau, almost 75% of our population will live within 100 miles of a United States coastline, regardless of anything we do here today. We cannot mandate where families live, and we cannot forcefully relocate families living in cities like Miami, New Orleans, Seattle, Los Angeles, St. Louis, Memphis, and New York City

Today, we may hear that there is no longer a lack of available and affordable homeowners' insurance. We may also hear that there is an overabundance of reinsurance capacity. Tell that to Mrs.

O'Shaughnessy. Tell that to the hundreds of thousands of families who are forced into insurance pools of last resort across the country, which in some areas have grown by more than 800% over the last six years.

Mr. Chairman, we could wait to take action until Congress is forced to act in the wake of some future earthquake or hurricane, or we could proceed deliberately and calmly without the environment of crisis that

would accompany a major catastrophe. Mr. Chairman, one way is a responsible approach to public policy-making—the other is not.

I strongly urge the Committee to move forward with our proposal in a timely manner in the hope that the legislation can be considered on the House Floor in September.

Thank you.

**Representative Barbara Lee**  
**For insertion in the record.**

**July 30, 1999**

**Full Committee Hearing on H.R. 21**  
***Homeowners' Insurance Availability Act of 1999***

**Question to Deputy Secretary of the Treasury Stuart Eizenstat:**

**In your testimony, you repeated Secretary Summer's common-sense principles about Federal involvement in reinsurance. One of these principles is that federal involvement must support, nor supplant, private insurance markets.**

**And that it must be partial, applying only to true catastrophes that the private market is not capable of handling; and that**

**It must be strictly transitional, phasing out as private markets develop.**

**And the other principle is that Federal involvement must share, not subsidize risk.**

**One basic principle of the business of insurance, I expect, is to collect a sufficiently large pool of insurees so that the profits from the premiums will have the capability of covering expected losses.**

**If the private insurance industry does not want to sell insurance to everyone in the largest pool possible, but cherry-pick, why should the government be left to underwrite these policies in order to cover policies sold by the industry as well as the uninsured?**

**I have tried to look at this kind of insurance as I would health care. If insurance companies could, they would only want to sell health insurance to the healthiest and the wealthiest of buyers of health insurance. They would screen out people with profiles of costly diseases – and not cover the people who would most need health care coverage. Should we, as a society, allow medical insurance companies to only cream their customers and sift out the poor and the potentially diseased?**

**Is disaster insurance any different? If disaster insurance for everyone within a disaster area is not sufficiently profitable for the industry, why shouldn't the government, state or federal, develop an insurance pool which covers everyone in an area – thus creating a sound pool of premiums, collect the profits, and pay out the losses.**

**(I don't understand why the government should underwrite losses without receiving some of the premiums.)**

**In actuarial terms, don't you think that this would work?**

Rep. Ed Royce  
Hearing on H.R. 21  
July 30, 1999

Mr. Chairman, I want to commend you for holding this morning's hearings on H.R. 21, the Homeowner's Insurance Availability Act of 1999. I also want to commend Chairman Lazio, the sponsor of this legislation, for focusing the committee's attention on the critical issues of catastrophic natural disasters.

However, while I appreciate Mr. Lazio's intent, I must express my deep concern about this legislation, which has the potential to undermine the private marketplace for reinsurance.

Being from California, a state that has considerable experience with natural disasters, I understand the concern about catastrophic losses which result from earthquakes, hurricanes and other natural disasters. But I do not believe that this kind of federal disaster reinsurance program is the appropriate way to address those concerns.

To begin with, this legislation would establish so-called "trigger" levels, or the amount of losses above a deductible at which reinsurance offered by the federal government would kick in. As we contemplate a federal program of disaster reinsurance, it is critically important that we understand what the capacity of the private marketplace is, so we can better determine whether such a program would provide coverage that competes with, and potentially crowds out the private marketplace.

This legislation is premised on the view that the supply of reinsurance in the private marketplace is not adequate to meet the demands of a catastrophic natural disaster. But before we decide to turn over to the federal government the role of providing reinsurance, let's consider that recent studies indicate that the capacity of the private marketplace to handle catastrophic losses is far greater than is contemplated by H.R. 21, which sets trigger levels at \$2 billion.

For example, a 1995 study by the U.S. Re Corporation which has been cited frequently by this committee as an authoritative analysis of the total supply of reinsurance has now been updated by a much more recent July 1999 study. The U.S. Re Corporation's revised analysis suggests that for much of the country, capacity has more than doubled from \$7 billion to \$14 billion per region since the 1995 report was produced.

A similar conclusion was reached in a study by Renaissance Reinsurance, with the increased capacity for California pegged at \$11 billion. In addition, both reports suggest that additional capacity is available from other forms of reinsurance agreements and from the capital markets, which have brought significant new capital to the table by securitizing natural disaster risk. Taken together, there is closer to \$20 billion of reinsurance available per region, significantly greater capacity than the outdated figures upon which this legislation is based.



These numbers are significant because they help to illustrate the fact that the private marketplace for reinsurance has grown significantly in recent years, and is much better prepared to handle catastrophic natural disasters. Indeed, as a third study conducted by the Wharton school and published just two weeks ago, concluded, "the gaps in catastrophic risk financing are presently not sufficient to justify Federal government intervention in private insurance markets in the form of catastrophe reinsurance."

A massive new federal disaster program would only hinder further innovation and growth in the private sector, potentially pushing out private reinsurance companies and leaving the taxpayer with much greater liability.

Tal P. Piccione  
Chairman, President &  
Chief Executive Officer

U.S. RE Corporation  
Reinsurance Brokers & Consultants



July 28, 1999

Representative Jim Leach  
2186 Rayburn House  
Office Building  
Washington, DC 20515

RE: Catastrophe Excess of Loss Reinsurance Availability in the U.S.A.

Dear Sir:

U.S. RE Corporation is pleased that it has been cited in the July 23<sup>rd</sup>, 1999 memorandum from the Majority Staff to the Legislative Assistants' Committee on Banking and Financial Services. This memorandum discusses catastrophe exposures and we presume data contained therein will be discussed at the hearing of July 30<sup>th</sup>, 1999 on HR.21, The Homeowners Insurance Availability Act of 1999.

In the fourth paragraph of the Memorandum, it mentions that U.S. RE has publicly stated that the total supply of available reinsurance in any single region of the United States is approximately \$7 billion. We wish to point out that this information is now substantially outdated, as it was based on an analysis our company performed in 1995/96. Since then, the capacity for catastrophe reinsurance protection has grown dramatically. In fact, based upon an analysis we have just completed, we estimate that the catastrophe reinsurance capacity for four of the key regions of the U.S.A. has now more than doubled, as follows:

North East	\$13.0 - 14.0 Billion
Carolinas	\$12.5 - 13.5 Billion
South East	\$13.0 - 14.0 Billion
Gulf & Texas	\$14.5 - 15.0 Billion

We enclose copies of our exhibit which reflects this revised analysis for your convenience. We would also like to point out that based upon our estimate, the aforementioned amounts can be increased by as

---

88 Park Avenue  
New York, New York 10018  
212-686-6200 Fax: 212-686-6206  
Telex: 179037 US RE CORP

such as ACP, which is among the availability of the additional insurance capacity coming from proportional reinsurance, treaty reinsurance, joint risk pools of U.S. reinsurance and American reinsurance. Moreover, additional capacity is now available from the capital markets which began to emerge in 1974. This capacity has grown since 1974-75 to approximately \$1 billion in any one year. Consequently, the aggregate capacity is estimated to increase from \$20 billion of 1974 to any one year. We also further believe that catastrophic capacity from the capital markets will grow more significantly now that investors in the security sector have begun to actively support securitization products that in the elimination of catastrophic risk.

Considering that insurers themselves are generally prepared to retain a certain level of losses after deducting reinsurance from reinsurance and other risk transfer devices, we believe that any legislation calling for a federal reinsurance mechanism should be formulated such that the federal program should not operate or trigger below an industry loss of between \$25 to \$30 billion. Furthermore, we believe that the trigger level established should be adjustable to meet future changes in capacity available from private sector mechanisms. With the foregoing in mind, U.S. RE Corporation urges the Committee and members of Congress to ensure that H.R. 21 or any similar type of proposed legislation will not be formulated in such a way as to compete with private sector reinsurance capacity.

We are prepared to assist your Committee with any clarification or further information and remain at your disposal.

Sincerely,



U.S. RE  
or  
2010

cc: Frank Nutter

July 1999

US RE  
Reinsurance Brokers & Consultants

## Catastrophe Excess of Loss Reinsurance Capacity on Zonal Basis



**NOTE:** Total aggregate catastrophe capacity written throughout all zones in the USA is estimated at least US\$35 Billion but recovers on a per zonal basis is committed as per above analysis.





Renaissance Reinsurance Ltd.  
 Renaissance House, East Broadway  
 P.O. Box HM 2527  
 Hamilton HMGX, Bermuda  
 Phone: (441)-295-4513  
 Fax: (441)-292-9453

**DATE:** June 11, 1999 **TIME:** 4:31 PM  
**TO:** Frank Nutter **COMPANY:** RAA  
**FROM:** Bill Riker, President & COO  
**Re:** Reinsurance Catastrophe Capacity

Dear Frank,

Thank you for inquiring about our views on the available catastrophe capacity by region in the United States. As you know, Renaissance Re is one of the largest catastrophe writers in the world. As part of this activity we maintain an exhaustive database of all catastrophe offerings we consider and pride our selves in having the most comprehensive database of catastrophe cover actually purchased in the U.S.

We run a variety of probabilistic models against this database of catastrophe contracts to determine and understand the dynamics of the risk in the market. Up until now we have maintained this information as proprietary to ourselves, but at your request, we are willing to release a certain amount of the information we have assembled. It must be understood that the information is our best attempt to model the reinsurance business and is subject to some degree of interpretation.

Attached is an exhibit, which outlines the capacity available by major risk territory in the US. To clarify, this is the actual amount we calculate would be paid by the reinsurance market in very large events.

Total Maximum recoverable in an Event (millions)

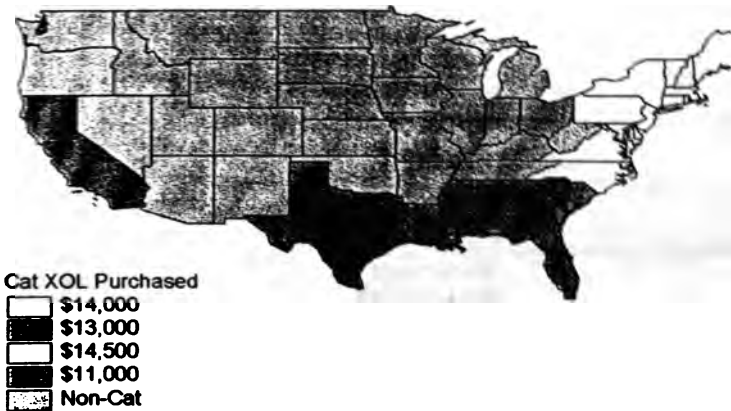
Region	Cat XOL Purchased
Northeast	14,000
Southeast	13,000
California	11,000
New Madrid	14,500

\* CAT XOL - Natural catastrophe Excess of loss reinsurance provides a defined limit of coverage that indemnifies the company above a specified loss amount.

As you can see, our data indicates there is about \$14 billion in capacity per event by region currently purchased by the primary insurance market at this time. We also believe

there is additional capacity available in the cat excess of loss market, but many insurance companies have decided to retain the risk on their own balance sheets. Also there is additional reinsurance protection that will be payable following a natural disaster from proportional, facultative and per risk excess of loss reinsurance agreements. More research needs to be done to ascertain the amount of additional reinsurance protection from these products, but we believe these products add about 40% more potential recovery.

## Total Maximum Recoverable



Thank you for your inquiry and hope you find this information helpful.

Best regards,

William I. Riker

**CAN INSURERS PAY FOR THE "BIG ONE"?  
MEASURING THE CAPACITY OF THE INSURANCE MARKET TO RESPOND  
TO CATASTROPHIC LOSSES**

By

**J. David Cummins, Neil Doherty, and Anita Lo  
Wharton School  
University of Pennsylvania**

July 14, 1999

Address Correspondence to: **J. David Cummins  
Wharton School  
3641 Locust Walk  
Philadelphia, PA 19104-6218**

**J. David Cummins  
Phone: 215-898-5644  
Fax: 215-898-0310**

**Neil Doherty  
Phone: 215-898-7652  
Fax: 215-898-0310**

**Anita Lo  
Phone: 215-898-3589  
Fax: 215-898-0310**

**e-mail: [cummins@wharton.upenn.edu](mailto:cummins@wharton.upenn.edu) [doherty@wharton.upenn.edu](mailto:doherty@wharton.upenn.edu) [anita77@wharton.upenn.edu](mailto:anita77@wharton.upenn.edu)**

**This paper is preliminary and confidential. Please do not quote without the authors' permission.**

**Can Insurers Pay For The "Big One"?  
Measuring The Capacity of the Insurance Market to Respond to Catastrophic Losses**

J. David Cummins, Neil Doherty, and Anita Lo  
July 14, 1999

**Abstract**

This paper presents a theoretical and empirical analysis of the capacity of the U.S. property-liability insurance industry to finance major catastrophic property losses. The topic is important because catastrophic events such as the Northridge earthquake and Hurricane Andrew have raised questions about the ability of the insurance industry to respond to the "Big One," usually defined as a hurricane or earthquake in the \$100 billion range. At first glance, the U.S. property-liability insurance industry, with equity capital of more than \$300 billion, should be able to sustain a loss of this magnitude. However, the reality could be different: depending on the distribution of damage and the spread of coverage as well as the correlations between insurer losses and industry losses. Thus, the prospect of a mega catastrophe brings the real threat of widespread insurance failures and unpaid insurance claims.

Our theoretical analysis takes as its starting point the well-known article by Borch (1962), which shows that the Pareto optimal result in a market characterized by risk averse insurers is for each insurer to hold a proportion of the "market portfolio" of insurance contracts. Each insurer pays a proportion of total industry losses; and the industry behaves as a single firm, paying 100 percent of losses up to the point where industry net premiums and equity are exhausted. Borch's theorem gives rise to a natural definition of industry capacity as the amount of industry resources that are deliverable conditional on an industry loss of a given size. In our theoretical analysis, we show that the necessary condition for industry capacity to be maximized is that all insurers hold a proportionate share of the industry underwriting portfolio. The sufficient condition for capacity maximization, given a level of total resources in the industry, is for all insurers to hold a net of reinsurance underwriting portfolio which is perfectly correlated with aggregate industry losses. Based on these theoretical results, we derive an option-like model of insurer responses to catastrophes, leading to an insurer response-function where the total payout, conditional on total industry losses, is a function of the industry and company expected losses, industry and company standard deviations of losses, company net worth, and the correlation between industry and company losses. The industry response function is obtained by summing the company response functions, giving the capacity of the industry to respond to losses of various magnitudes.

We utilize 1997 insurer financial statement data to estimate the capacity of the industry to respond to catastrophic losses. Two samples of insurers are utilized – a national sample, to measure the capacity of the industry as a whole to respond to a national event, and a Florida sample, to measure the capacity of the industry to respond to a Florida hurricane. The empirical analysis estimates the capacity of the industry to bear losses ranging from the expected value of loss up to a loss equal to total company resources. We develop a measure of industry *efficiency* equal to the difference between the loss that would be paid if the industry acts as a single firm and the actual estimated payment based on our option model.

The results indicate that national industry efficiency ranges from about 78 to 85 percent, based on catastrophe losses ranging from zero to \$300 billion, and from 70 to 77 percent, based on catastrophe losses ranging from \$200 to \$300 billion. The industry has more than adequate capacity to pay for catastrophes of moderate size. E.g., based on both the national and Florida samples, the industry could pay at least 98.6 percent of a \$20 billion catastrophe. For a catastrophe of \$100 billion, the industry could pay at least 92.8 percent. However, even if most losses would be paid for an event of this magnitude, a significant number of insolvencies would occur, disrupting the normal functioning of the insurance market, not only for property insurance but also for other coverages.



We also compare the capacity of the industry to respond to catastrophic losses based on 1997 capitalization levels with its capacity based on 1991 capitalization levels. The comparison is motivated by the sharp increase in capitalization following Hurricane Andrew and the Northridge earthquake. In 1991, the industry had \$0.88 in equity capital per dollar of incurred losses, whereas in 1997 this ratio had increased to \$1.56. Capacity results based on our model indicate a dramatic increase in capacity between 1991 and 1997. For a catastrophe of \$100 billion, our lower bound estimate of industry capacity in 1991 is only 79.6 percent, based on the national sample, compared to 92.8 percent in 1997. For the Florida sample, we estimate that insurers could have paid at least 72.2 percent of a \$100 billion catastrophe in 1991 and 89.7 percent in 1997. Thus, the industry is clearly much better capitalized now than it was prior to Andrew.

The results suggest that the gaps in catastrophic risk financing are presently not sufficient to justify Federal government intervention in private insurance markets in the form of Federally sponsored catastrophe reinsurance. However, even though the industry could adequately fund the "Big One," doing so would disrupt the functioning of insurance markets and cause price increases for all types of property-liability insurance. Thus, it appears that there is still a gap in capacity that provides a role for privately and publicly traded catastrophic loss derivative contracts.

**Can Insurers Pay For The "Big One"?  
Measuring The Capacity of the Insurance Market to Respond  
to Catastrophic Losses**

J. David Cummins, Neil Doherty, and Anita Lo

July 14, 1999

**1. Introduction**

Catastrophic events such as the Northridge earthquake and Hurricane Andrew each cost the insurance industry in excess of \$10 billion. While most insured losses were paid, each event resulted in insurer insolvencies and illustrate the potential stress facing insurance markets. Andrew, which cost the insurance industry about \$17 billion,<sup>1</sup> would have been much more severe had its path veered slightly to hit Miami. Moreover, scenarios constructed by catastrophe modelers suggest the feasibility of a \$76 billion hurricane in Florida, a \$21 billion Northeast hurricane, a \$72 billion California earthquake and a \$101 billion New Madrid earthquake.<sup>2</sup> At first glance, it might appear that the insurance industry would be available to pay for such mega catastrophes. The U.S. property liability insurance industry's equity capital, is somewhat over \$300 billion. This capital is potentially available to pay for losses which exceed the reserves (established for their payment from premiums). However, the reality would be different; depending on the distribution of damage and the spread of coverage, many insurers would become insolvent.<sup>3</sup> Technically, this problem should be solved by the state operated

---

<sup>1</sup>Source Property Claims Services of the American Insurance Services Group.

<sup>2</sup>These figures relate only to the insured damage. The total damage would be higher. For hurricane losses a substantial portion of total losses is likely to be insured. However, for earthquake losses, many properties are not insured and others carry high deductibles. Thus, for earthquake losses the total societal loss could be multiples of this estimate. These figures were produced in a study by Risk Management Solutions (2.5.95) though similar "ballpark" figures are being produced in other studies.

<sup>3</sup>Insurers can spread their liabilities to other insurers through reinsurance. In principle, the effects of catastrophes can be spread through the worldwide reinsurance market. In practice the available capacity of reinsurers is limited even though it has increased significantly since Hurricane Andrew. Although estimates vary, it seems clear that a substantial gap exists between existing reinsurance coverage and a catastrophic loss exceeding the \$15-20 billion range. For example, Swiss Re (1997) estimated that reinsurers would pay 39 percent of a U.S. one-in-100-year catastrophe loss such as a \$56 billion hurricane or a \$65 billion earthquake in California. The Swiss Re study estimated a worldwide total of \$53 billion in catastrophe excess of loss reinsurance in place in 1997. The reinsurance brokerage

insurance guaranty funds which re-allocate defaulted liabilities among solvent insurers. But these only operate within small limits,<sup>4</sup> and even this burden would stretch the already strained resources of surviving insurers. Thus, the prospect of a mega catastrophe brings the real threat of widespread insurance failures and unpaid insurance claims. Moreover, surviving insurers would be so depleted of surplus, and thus over-levered, they would have to reduce the future sale of all types of property-liability insurance causing price increases and severe availability problems.<sup>5</sup>

These scenarios have led both state and federal governments to contemplate legislative solutions involving the government as a reinsurer and directly enlisting capital markets as providers of catastrophe capital (Lewis and Murdock, 1996, Cummins, Lewis and Phillips, 1999). Both Florida and California have such proposals and the Natural Disaster Protection Act was introduced in Congress in 1993 with similar provisions. Moreover, the vulnerability of insurance markets had led to financial market innovations such as the catastrophe options traded on the Chicago Board of Trade. New instruments have appeared such as CAT Bonds in which borrowers contract for some degree of debt forgiveness in the event of a predefined catastrophe. Another innovative instrument is the CatEPut in which re-capitalization can be achieved after a catastrophe by the firm's exercising a put option on its own stock. Also, in the absence of adequate reinsurance, insurers have sometimes swapped their catastrophe exposures.

In this paper, we conduct a theoretical and empirical analysis of the capacity of the insurance industry to respond to catastrophic events. Given appropriate technical (weather, seismic, etc) data, plus descriptions of

---

firm Guy Carpenter estimates that the excess of loss reinsurance capacity of the reinsurance market to reinsure any one primary insurer was about \$500 million in both 1997 and 1998 (Guy Carpenter, 1998). Renaissance Reinsurance Company estimates that reinsurers would pay about \$14 billion from existing excess of loss reinsurance programs in each of four U.S. regions - the Northeast, the Southeast, the New Madrid region, and California. Other forms of reinsurance could increase this by 40 percent. (letter from William Riker, President and COO, Renaissance Reinsurance Ltd., June 11, 1999).

<sup>4</sup> Guaranty funds limit the amount paid for any given loss, typically to \$300,000, as well as limiting the annual assessment against solvent insurers to 2 to 3 percent of premiums.

<sup>5</sup>See Froot, Scharfstein and Stein (1993) and Cummins and Danzon (1997).

insured properties for each insurer, one can estimate an insurer response for any given event such as a force 5 hurricane hitting Miami or an 8.2. earthquake in San Francisco. Such scenario analysis is carried out by modeling firms such as Applied Insurance Research and Risk Management Solutions. However, there is a very large number (approaching infinite) of potential catastrophe scenarios, and the data demands for conducting such an analysis for the entire insurance industry are enormous. Moreover, while such scenarios are valuable for planning at the firm level, they provide too much detail for assessing the efficiency of the insurance market in spreading risk. Rather, we seek a more general response function. We estimate the distributional characteristics of catastrophic losses and allocate such losses to individual insurers by use of correlations and financial data. The result is a function that defines the estimated deliverable insurance payments conditional on any given size of aggregate catastrophic loss. By default, it also estimates the capital that will be lost through insurer insolvencies.

Such a measure of capacity rests on two broad components; size and diversification – how much equity or “surplus” is available and how effectively the riskiness of insurance losses is spread though the insurance market. The traditional instrument to spread risk between insurers is reinsurance. By buying and selling “options” on their portfolios with each other, and to specialized reinsurers, insurers can change the risk characteristics of their portfolios. In a paper that anticipated the capital asset pricing model, Borch (1962), showed that the value maximizing trades would leave all insurers holding net of reinsurance portfolios defined solely on the market aggregate loss and that insurance would be priced solely on the correlation with this aggregate portfolio. We show that the distribution of insurance liabilities which minimizes insolvencies, and thereby maximizes payments to policyholders, is similar to Borch’s equilibrium. However, this structure also provides a framework for measuring the available capacity of the industry to respond to major catastrophes.

The paper is organized as follows: Section 2 sets forth our theory of industry capacity and derives the option-like model used in our capacity estimation. Section 3 discusses sample selection and our empirical approach to estimating capacity. Section 4 presents the results, and section 5 concludes.

## 2. Diversification And The Mutuality Principle

In this section, we develop a theoretical model of capacity in an insurance market. We begin by

examining a baseline case in which the liabilities in an insurance market are distributed amongst insurers so as to maximize payouts to policyholders for any given loss scenario. The baseline case establishes a basic relationship between the capacity of the insurance industry to respond to catastrophic loss experience and the correlation structure of its liabilities. We then derive a measure of capacity which is parameterized by these correlations together with other firm and market features.

#### A Definition of Insurance Capacity

We examine a baseline case in which the liabilities in an insurance market are distributed amongst insurers so as to maximize payouts to policyholders for any loss scenario. This base case is useful for defining industry capacity and also provides a yardstick for measuring capacity. In the baseline case, insolvencies will be minimized for any given level of industry losses and thus actual payments to policyholders will be maximized.

It is well known that in a market in which risk bearing is costly to firms but where transacting between firms is costless, the Pareto optimal risk sharing arrangement is one in which the industry "mutualizes" its risk in the sense that all insurers hold the same net (after reinsurance) liability portfolio. This result, due to Borch (1962), is identical to (and preceded) the capital asset pricing model. According to Borch, the Pareto optimal reinsurance arrangement is one in which each insurer holds a net (after reinsurance) portfolio which is a proportionate claim on total insured losses,  $L$ . This result is equivalent to the CAPM proposition that each investor will hold the market portfolio. The implication is that all insurers' portfolios are perfectly correlated after reinsurance transactions have been exploited. After all possibilities for diversification through reinsurance are exhausted, insurers will hold the same loss portfolio though the scale may differ. The aggregate loss for the market is  $\sum L_i = L$ , where  $L_i$  = the loss sustained by insurer  $i$ . The riskiness of the aggregate portfolio will depend on the total number of individual policies insured, " $n$ ", and on their correlations. If the number of policyholders is very large and the policy correlations are low then, by the law of large numbers,  $L$  will have little risk ( $\sigma(L/n) \rightarrow 0$  as " $n$ "  $\rightarrow \infty$ , where  $\sigma(L/n)$  = the standard deviation of average losses per policy). But with small " $n$ " and/or high correlation among insured losses,  $L$  will have higher risk.

To address the implications of limited liability, first consider the terminal value of equity,  $T$ , of an

insurer,  $i$ , in a simple one period model:

$$(1) \quad T_i = \text{MAX}\{(P_i + Q_i^0)(1+r) - \alpha_i L_i; 0\}$$

where  $Q_i^0$  is opening equity or "surplus" for insurer  $i$ ,  $P_i$  is premium income net of expenses, and  $r$  is the rate of return on investments. Insurer  $i$  is assumed to hold a proportionate share  $\alpha_i$  of the market insurance portfolio so that its losses  $L_i = \alpha_i L$ . For simplicity, assume that the market is competitive, thus  $P_i = E(L_i)/(1+r)$ . Denoting  $Q_i = Q_i^0(1+r)$ , terminal equity is re-stated as:

$$(1') \quad T_i = \text{MAX}\{E(L_i) - L_i + Q_i; 0\}$$

Now consider the implications of limited liability for policyholders. The amount which insurer " $i$ " can pay to policyholders,  $L_i^p$ , is the minimum of the face value of its liability or its financial resources which, in this model are the sum of equity and net premiums  $Q_i + E(L_i)$ , i.e.,

$$(2) \quad L_i^p = \text{MIN}\{L_i; Q_i + E(L_i)\}$$

If there is a bad draw from the loss distribution, i.e., a catastrophic loss, the ability of the insurer to pay the unexpected loss  $L_i - E(L_i)$  depends on the surplus  $Q_i$ . If we scale up this problem, then the ability of the market to respond to unexpected losses depends on the total industry surplus, but also on how the liabilities and surplus are distributed across insurers. We will use this concept to define and measure market capacity.

If we compare this limited liability world with Borch's equilibrium, there is an apparently stark contrast. In Borch's world, insurers are risk averse and will gain from risk sharing through reinsurance transactions. In our limited liability model, insurers own a put option on the value  $E(L_i) + Q_i - L_i$  where the striking price is  $E(L_i) + Q_i$  and the value of this option will increase as variance of the underlying asset (in this case the loss portfolio) increases. Thus, apparently, insurers would not engage in risk reducing reinsurance transactions. We can add more structure to resolve this difference by allowing premium rates to depend on insurer risk.<sup>6</sup> This additional structure is not necessary for our present task, but it does focus our attention on what the payouts to policyholders would be when insurers are perfectly diversified as shown by Borch.

---

<sup>6</sup>See Doherty and Tinic (1982) and Cummins and Danzon (1997).

Consider a Borch equilibrium in which each insurer, "i" holds a share  $\alpha_i$  of L and assume that each insurer's surplus is scaled to its share of aggregate loss. The first implication is that the aggregate terminal equity of insurers will be the difference between the unexpected industry loss  $E(L) - L$ , and the industry equity  $\sum Q_i$  as shown in equation (3a) below. The second implication is that the industry's whole surplus will be available to meet unexpected losses. Thus, the amount of aggregate losses that will be paid to policyholders,  $L^p$ , will be the minimum of the face value of losses L and the industry's total resources  $E(L) + Q$ , as shown in equation (3b).

$$(3a) \quad \sum_{i=1}^N T_i = \text{MAX} \left\{ \sum_{i=1}^N [\alpha_i E(L) + Q_i - \alpha_i L]; 0 \right\} = \text{MAX} \left\{ E(L) + \sum_{i=1}^N Q_i - L; 0 \right\}$$

$$(3b) \quad \sum_{i=1}^N L_i^p = \text{MIN} \left\{ L; E(L) + \sum_{i=1}^N Q_i \right\}$$

where N = the total number of insurers in the market. Currently, the U.S. property-liability insurance industry's equity capital is about \$300 billion. If our model applied to the industry, the entire amount of the equity capital would be available to pay unexpected losses. In effect, with perfect diversification, the industry acts as a single firm. No one firm would become insolvent until the entire industry capital is exhausted and, at this point, all firms would simultaneously become insolvent. This equilibrium distributes industry liabilities and resources in a way that maximizes payouts to policyholders.

*Definition: For any configuration of losses for which insurers are liable, the capacity of the insurance market is the proportion of those liabilities that is deliverable given the financial resources of firms on whom the losses fall and given all arrangements (such as reinsurance, guarantee funds, etc) for re-allocating those losses among insurers.*

In the equilibrium considered, all industry surplus would be accessible by policyholders.

#### Conditions for Capacity Maximization

Consider each insurer's aggregate loss as the sum of its catastrophe exposure and its idiosyncratic risk. Part of the individual insurer loss,  $d_i$ , is idiosyncratic and diversifiable; i.e.,  $\text{COV}(d_i, d_j) = 0$  for all  $i \neq j$ . The

remaining part of the insurer's loss is catastrophe risk in the sense that all insurers are exposed to highly correlated losses,  $L_U$ , from events such as hurricanes and earthquakes. The proportion of the total pool of catastrophe losses written by insurer "i" is  $c_i$ . Thus, the loss of insurer i is:

$$(4) \quad L_i = c_i L_U + d_i$$

Given that  $\sum L_i$  must equal the aggregate industry losses,  $L = L_U + D$ ; (where  $D = \sum d_i$  is the total industry diversifiable losses), then  $\sum c_i = 1$ . The essential characteristic of diversifiable risk is that it will tend to zero if a large enough number of policies is insured. To provide a rationale for a reinsurance market, we assume that any individual insurer holding  $n_i$  policies is insufficiently diversified to secure this risk elimination, but the total insurance market having  $\sum n_i = n$  policies does effectively eliminate risk, i.e.,

$$(5) \quad \sigma\left(\frac{D}{n}\right) = 0; \quad \sigma\left(\frac{d_i}{n_i}\right) \neq 0; \quad \sigma\left(\frac{c_i L_U}{n_i}\right) \neq 0; \quad \sigma\left(\frac{L_U}{n}\right) = 0$$

The first expression in (5) says that diversifiable risk can be substantially eliminated by diversification across the marketplace. The second expression says that each individual insurer's endowment of potentially diversifiable exposures is not sufficient to eliminate this risk (i.e., it does not have sufficient policies to exploit the law of large numbers). The third and fourth expressions in (5) assert that the risk of  $L_U$  is not diversifiable (i.e., losses are positively correlated). The third expression is particularly important in providing a rationale for insurance. By definition of  $d_i$  and  $c_i L_U$ , the former can be reduced through further risk spreading whereas the latter cannot.

We now develop the following necessary condition for optimal risk sharing behavior:

**PROPOSITION:** *A necessary condition for the average industry capacity per policyholder,  $\sum_i E(L_i^*)/n$ , to be maximized is that all firms hold a net of reinsurance portfolio which is proportional to  $L_U$  and  $D$ .*

The proposition requires that all insurers hold portfolios of the form  $\alpha_i L = c_i L_U + k_i D$  where  $\alpha_i$ ,  $c_i$ , and  $k_i$  are firm specific constants.<sup>7</sup> Suppose that this were not true, then at least one insurer would hold a portfolio

---

<sup>7</sup>It will be noticed that the reinsurance structure that maximizes industry capacity ( $\alpha_i L = c_i L_U + k_i D$  for all i) is of similar structure to the Pareto optimal reinsurance market identified by Borch (1962). The similarity is more pronounced when it is noticed that, since  $D$  is diversifiable, the value of  $k_i$  makes little difference to the availability of surplus to pay catastrophic losses. Thus, one can consider the special case in which  $\alpha_i = k_i$ . However, even for this special case, our result and that of Borch are not necessarily identical. While, in both results, insurers' loss portfolios are defined solely on  $L$ , we rely on a



containing some idiosyncratic risk; i.e.,  $\alpha_i L_U + d_i$  where  $d_i \neq k_i D$ . Since  $D = \sum_{j=1}^N d_j$ , the existence of one insurer holding  $c_i L_U + d_i$  implies that all other insurers must hold in total

$$(1 - c_i) L_U + D - d_i = \sum_{j \neq i}^N c_j L_U + D - d_i$$

which cannot be of the form

$$\sum_{j \neq i}^N c_j L_U + \sum_{j \neq i}^N k_j D$$

since  $d_i \neq k_i D$  and  $D = \sum d_i$ .<sup>5</sup> Thus, at least one other insurer must hold a portfolio of the form  $c_j L_U + d_j$  where  $d_j \neq k_j D$ . Of the universe of insurers "M" we define a subset "m<sub>1</sub>" having such "undiversified" portfolios  $\alpha_i L_U + d_i$  and subset "m<sub>2</sub>" having "diversified" portfolios of the form  $\alpha_j L_U + k_j D$ . Since

$$(1 - \sum_{j \in m_2} k_j) D = \sum_{i \in m_1} d_i$$

then the following mutual exchange is possible. All type m<sub>1</sub> insurers pool their diversifiable risk which leads to an aggregate m<sub>1</sub> diversifiable liability of  $(1 - \sum_{j \in m_2} k_j) D$ . Now define a set of weights  $k'_i$  and apportion this aggregate liability over m<sub>1</sub> insurers such that each assumes a liability of :

$$k'_i (1 - \sum_{j \in m_2} k_j) D = k_i D \quad \text{since } k'_i = k_i \left( \frac{1}{1 - \sum_{j \in m_2} k_j} \right) \text{ and } \sum_{j \in m_1} k'_j = 1$$

These conditions ensure that  $\sum k_i = 1$  (i.e. that diversifiable risk D is fully allocated over all insurers). Since the only requirement placed on  $k'_i$  is that it sum to unity, these weights can be chosen such that the  $E(d_i) = E(k_i D)$ .

maximization of aggregate dollar surplus whereas Borch relied on expected utility maximizing trade between risk averse insurers. The non-linearity in our results comes from the truncating effects of insolvency whereas non-linearity in Borch's reinsurance structure comes from the parameters of the various insurers utility functions.

<sup>5</sup>To see this, consider that all other insurers did hold portfolios of the form  $\sum_{j \neq i} \alpha_j L_U + \sum_{j \neq i} k_j D$ . Thus the total of the diversifiable risk portfolios of all insurers would be:

$$(a). \quad D = \sum_{j \neq i} k_j D + d_i$$

This can be re-stated as

$$(b). \quad D = \sum_{j \neq i} k_j D + k_i D - k_i D + d_i = \sum_j k_j D + (d_i - k_i D)$$

which is equal to

$$(c). \quad D = D + (d_i - k_i D)$$

since  $\sum_j k_j = 1$ . However, since  $d_i \neq k_i D$ ; then (c), and therefore (a), is contradicted.

Thus, these transactions will leave all  $m_2$  insurers unaffected and will leave the expected face value of liability of all  $m_1$  unchanged. However, since  $\sigma(d_i/n_i) > 0$ ; and  $\sigma(k_i D/n_i) = 0$ , these transactions are mean preserving, and risk reducing, for all  $m_1$  insurers. Now since the payable loss on any insurer is a short position in a put option, its value will increase as its standard deviation is reduced. Consequently, these transactions will leave  $E(L_i^p/n)$ , where  $L_i^p$  is defined by (3b), unchanged for all  $m_2$  insurers but increased for all  $m_1$  insurers. As a result, aggregate available industry capacity  $\sum_i E(L_i^p/n)$  will be increased. Q.E.D.

The proposition shows the necessary conditions for capacity maximization. The sufficient conditions concern the relationship between the liability allocation,  $\alpha_i$ , and the distribution of surplus,  $Q_i$ , across insurers. The effect of surplus will become important in the capacity measures derived in the next section.

**COROLLARY:** *When the necessary conditions for maximization of capacity per policyholder  $\sum_i E(L_i^p/n)$  are satisfied, all insurers will hold net of reinsurance portfolios  $L_i$  that are perfectly correlated with aggregate industry losses,  $L$ .*

Note that  $\text{COV}(L_i; L) = E\{[c_i(L_{U_i} - E(L_{U_i})) + (d_i - E(d_i))][L - E(L)]\}$  which can be simplified to  $E\{[c_i(L_{U_i} - E(L_{U_i}))][L - E(L)]\}$  since  $d_i$  is independent of  $L$  by assumption. Using  $\text{COV}(D, L) = 0$  and  $L = L_{U_i} + D$ , we can write:  $\sigma^2(L) = E\{[L_{U_i} - E(L_{U_i})][L - E(L)]\}$ . Thus,  $\text{COV}(L_i; L) = c_i \sigma^2(L)$ . Proof of the corollary follows immediately from the proposition noting that  $\text{COV}(L_i; L) = c_i \sigma^2(L)$  and that  $c_i$  and  $k_i$  are constants. Q.E.D.

The corollary shows that each insurer must hold a net portfolio which is perfectly correlated with the aggregate insurable loss  $L$  to maximize capacity. This will provide a yardstick for measuring capacity. Since  $\alpha_i L = c_i L_{U_i} + k_i D$  maximizes capacity for a given initial industry surplus  $Q_i$ , and since this result is characterized by perfect correlation between all  $L_i$  and  $L$ , then it seems that the actual correlations will provide a measure of capacity utilization.

Various frictions can frustrate the conditions described in the proposition and corollary. In addition to factors that limit firm size, reinsurance and other insurer hedges are costly. Froot and O'Connell 1996, recently estimated the cost of catastrophe reinsurance from the complete set of contracts brokered by the largest reinsurance broker. The transaction cost, (Price-Expected Loss)/Expected loss, ranges between about 10% and 140% from 1970-1995. In the last decade of the series, the average transaction cost is about 65%. Several

explanations can be given for this high cost including diverging estimates of expected losses, moral hazard and excessive rent taking. Another explanation for incomplete diversification lies in the prospect that shareholders may seek to expropriate wealth from policyholders by choosing a high risk financial structure (Myers, 1977, and Doherty and Tinic, 1982). This expropriation will be mitigated by reputation effects and where the policyholders and/or their agents can monitor the financial condition and reinsurance purchases of their insurers. We now examine the relationship between capacity, correlations between insurer loss distributions, and the financial structure of insurers.

#### Correlations And Capacity Utilization For a Given Catastrophic Loss

Our task is to estimate the ability of the industry to respond to an abnormal loss experience defined by equation (3b). This is the industry response conditional on industry losses of any given size " $L$ ".

The response function is illustrated in Figure 1. The horizontal axis measures possible values for aggregate insurance industry losses, and the vertical axis measures the *expected* payout of all firms combined. Consider just two possible loss scenarios: first, a California earthquake that causes an industry loss of \$30 billion over and above the expected loss  $E(L)$  and, second, a combination of a Florida hurricane of \$20 billion and automobile losses that are \$10 billion above expected. Both scenarios lead to industry losses that are \$30 billion above expected value (denoted  $E(L)+30$ ). But the scenarios would impact different insurers and could lead to different numbers of insolvencies depending on the distribution of coverage across insurers. For example, the expected payout in the first scenario might be " $W$ " which is very low because much of the California earthquake coverage is from local insurers that are poorly diversified and poorly capitalized. However, the second scenario might be spread more evenly over firms and the payout is shown as " $Y$ ". Points  $W$  and  $Y$  are the conditional responses which are described below in equations (7) through (9). These are only two of many potential configurations that could result in industry losses of \$30 billion above expected value. The average of all possible payouts for all feasible scenarios which sum to \$30 billion above expected loss is denoted " $X$ ". This value,  $X$ , is the conditional response, i.e., the expected payout of the industry conditional on an industry loss of  $E(L) + \$30$  billion. The locus of all such conditional payouts is the response function which is shown as  $OZ$ . Notice that  $OZ$

lies at or below the 45° line and, we postulate, will diverge from the 45° line as loss realizations increase. The divergence implies that insolvencies will increase disproportionately with losses as more and more insurers are stressed and that failures are passed through the market via reinsurance thus causing "knock on" insolvencies.

It is useful to start with the average surplus per policy available to pay unexpected claims of insurer "i":

$$(6) \quad E\left(\frac{T_i}{n_i}\right) = \left(\frac{1}{n_i}\right) \int_0^{Z_i} [E(L_i) + Q_i - L_i] f(L_i) dL_i$$

(2)

where  $Z_i = E(L_i) + Q_i$ . To derive the conditional response function note that the aggregate industry terminal equity, conditional on, industry losses being  $L$ , is:

$$(7) \quad \sum_{i=1}^N E(T_i|L) = \sum_{i=1}^N \int_0^{Z_i} [E(L_i) + Q_i - L_i] f(L_i|L) dL_i$$

This value is shown in Figure 1 as the distance between  $E(L_i) + \sum Q_i$  and the response function OZ. Thus, the response function can be defined as  $R|L = E(L_i) + \sum Q_i - \sum_i E(T_i|L)$ .

To estimate the response function, it is necessary to make distributional assumptions about  $L$ . Using the normal distribution and using the properties of conditional moments, the response function becomes:

$$(8) \quad E(T_i|Q_{i0}, L) = (P_i + Q_{i0} - \mu_{L_i|L}) N\left[\frac{P_i + Q_{i0} - \mu_{L_i|L}}{\sigma_{L_i|L}}\right] + \sigma_{L_i|L} \frac{1}{\sqrt{2\pi}} e^{-\frac{1}{2}\left(\frac{P_i + Q_{i0} - \mu_{L_i|L}}{\sigma_{L_i|L}}\right)^2}$$

$$\text{where } \mu_{L_i|L} = \mu_i + \frac{\rho_i \sigma_i}{\sigma_L} (L - \mu_L) \text{ , and } \sigma_{L_i|L}^2 = \sigma_i^2 (1 - \rho_i^2)$$

where  $\rho_i$  is the correlation coefficient between  $L_i$  and  $L$  and  $\mu$  is used to denote expectation. Not surprisingly, this formulation resembles option pricing models. The response function is:

$$\text{where } C_i = \frac{P_i + Q_{i0} - \mu_{L_i|L}}{\sigma_{L_i|L}} \text{ ,}$$

$$(9) \quad R_i|L = P_i + Q_{i0} - E(T_i | Q_{i0}, L) = (P_i + Q_{i0}) N(-C_i) + \mu_{L,iL} N(C_i) - \sigma_{L,iL} n(C_i)$$

$N(\cdot)$  = the standard normal distribution function, and  $n(\cdot)$  = the standard normal density function. Note that  $R_i|L = f(E(L), E(L), \sigma(L), \sigma(L), r_i, Q_i : L)$ . Thus, we can measure the capacity utilization of the industry for any industry loss  $L$ , as a function of two industry variables  $\{E(L), \sigma(L)\}$  and four firm variables  $\{E(L_i), \sigma(L_i), r_i, Q_i\}$ .

Alternatively, the response function can be estimated under the assumption that firm and industry losses are jointly lognormal, leading to the following formulation:<sup>9</sup>

$$(10) \quad E(T_i | Q_{i0}, L) = (P_i + Q_{i0}) N(D_{1i}) - e^{D_{2i}} N(D_{1i} - \xi_i \sqrt{1 - \gamma_i^2})$$

$$\text{where } D_{1i} = \frac{\ln(P + Q_{i0}) - v_i - \frac{\xi_i \gamma_i}{\xi_L} (\ln L - v_L)}{\xi_i \sqrt{1 - \gamma_i^2}}, \text{ and } D_{2i} = v_i + \frac{\xi_i \gamma_i}{\xi_L} (\ln L - v_L) + \frac{\xi_i^2 (1 - \gamma_i^2)}{2}$$

The parameters  $v_i$  and  $v_L$  are lognormal drift parameters and  $\xi_i$  and  $\xi_L$  are lognormal risk parameters, in both cases for insurer  $i$  and the industry ( $L$ ), respectively. The parameter  $\gamma_i$  is the correlation coefficient between  $\ln(L)$  and  $\ln(L_i)$ . In the lognormal case the response function is:

$$(11) \quad R_i|L = P_i + Q_{i0} - E(T_i | Q_{i0}, L) = (P_i + Q_{i0}) N(-D_{1i}) + e^{D_{2i}} N(D_{1i} - \xi_i \sqrt{1 - \gamma_i^2})$$

Comparative statics analysis of the response functions (9) and (11) reveals that both are decreasing in  $\sigma_i$  and increasing in  $\rho_i$ , i.e., industry capacity is inversely related to  $\sigma_i$  and directly related to  $\rho_i$ .

---

<sup>9</sup>Equations (8) and (9) are derived in the Appendix.

### 3. Measuring the Capacity of the U.S. Insurance Industry

In this section we develop estimates of response functions for the U.S. property-liability insurance industry. We do this by selecting samples of insurers and estimating the parameters of equations (9) and (11). The response functions are then calculated for various values of  $L$ , the total industry loss. The overall objective of the analysis is to determine the ability of the U.S. insurance industry to respond to catastrophic losses and to measure the efficiency of the industry in spreading risk across the market. This section discusses the technique we use to measure industry efficiency as well as sample selection and parameter estimation. The results are presented in section 4.

#### Measuring Industry Efficiency

Recall from the preceding discussion that in a fully efficient insurance market, the industry responds to losses as if it were a single firm. The response function for an efficient market is thus given by the line OAC in Figure 1, i.e., an efficient insurance industry would pay 100 percent of all losses up to the point when all industry resources are exhausted. Thus, one measure of market inefficiency is the magnitude of the wedge between the fully efficient response function and the actual industry response function represented by the line OZ in Figure 1. We measure the area of the wedge bordered by line segment OA, the response curve OZ, and the dotted vertical line segment originating at the point  $V = E(L) + \sum Q_i$  on the horizontal axis. The ratio of the area under the response curve to the area of the triangle OAV is our primary measure of market efficiency. This area is equal to the area of the triangle minus the area of the wedge divided by the area of the triangle. For a fully efficient industry, market efficiency would equal 1; and for an inefficient industry, market efficiency is between 1 and 0. We also consider other measures of industry performance, including the percentage of the total losses that would be paid by the industry for catastrophes of various magnitudes and the number of insolvencies that result.

#### Sample Selection and Modeling Approach

The data for the study are taken from the regulatory annual statements filed by insurers with the National Association of Insurance Commissioners (NAIC). Our efficiency estimates are for the most recent report year currently available, 1997. To estimate parameters, we use data from the period, 1983-1997, providing fifteen

annual observations on the companies in the sample. Insurance prices and profits have been shown to be cyclical, with a cycle period between six and seven years (Cummins and Outreville, 1987). The fifteen year sample period thus gives us approximately two complete underwriting cycles. We decided not to extend the sample prior to 1983 because the number of insurers for which we have complete time series would have been reduced significantly by including earlier years. Although companies present in the data base for 1997 but not for earlier years are included in our capacity estimation, the companies present in the sample for the entire sample period (the *full-time series (FTS) companies*) are important because they are used to estimate regression models to obtain the parameters of the companies that are not present for the entire sample period (see below). To obtain reliable parameter estimates, it is important to include as many companies as possible in the FTS regressions.

Two samples of insurers were selected – a national sample and a Florida sample — to represent the capacity of the industry to respond to national catastrophes and to Florida catastrophes, respectively. Use of the national sample assumes that the total reserves and equity capital of the industry are potentially available to pay catastrophic losses, while the use of the Florida sample assumes that the total resources of companies operating in Florida are potentially available to pay the costs of a Florida catastrophe. Both the Florida and national estimates represent upper bound estimates of the industry's ability to respond to catastrophe claims. In both cases, the total resources of all insurers in the respective samples are assumed to be available to pay catastrophic loss claims, even though some insurers do not write policies likely to be triggered by a catastrophe. E.g., a company specializing in commercial liability insurance is not exposed to the property losses caused by a catastrophe and hence its resources would not be called upon to fund catastrophic loss claims. Moreover, the analysis based on the national sample assumes that all of the reserves and equity capital of the industry would be available to fund catastrophic losses, even though most catastrophes that are currently being projected by insurers and modeling firms are localized in one or a few states and only a subset of insurer are licensed in any given state. Thus, the actual amount of money that would be forthcoming from the insurance industry to fund any given catastrophic loss is expected to be smaller than projected in our analysis.

In selecting both the national and Florida samples, our objective was to maximize the number of

companies that could meaningfully be included in the analysis. Thus, the screening criteria applied in selecting the sample focused primarily on eliminating insurers that were not viable operating entities in 1997. Thus, we excluded companies from the sample that were experiencing severe financial difficulties or were in runoff mode, i.e., not actively participating in the market.<sup>10</sup> To be included in the Florida sample, insurers also were required to have positive losses in Florida in 1997.<sup>11</sup>

Ownership structure in the insurance industry also is likely to have an effect on market capacity. Many insurance firms are organized as *insurance groups*, consisting of several individual companies under common ownership. Under U.S. corporation law, the owners of the group hold a valuable option — the option to allow a financially troubled subsidiary to fail. The claimants against the insolvent subsidiary cannot reach the assets of other insurers in the group unless they succeed in “piercing the corporate veil,” which usually requires showing that the owners engaged in fraud or some other abnormal activity (Easterbrook and Fischel, 1985). Although the owners may decide to rescue a failing subsidiary to protect reputational or franchise value, they are under no legal obligation to do so. The default option may have particularly severe implications for the financing of catastrophic risk because the probability that franchise value will exceed the costs of a bailout is likely to be inversely proportional to the magnitude of the event. Thus, parents may choose to bail out failing subsidiaries for small catastrophes but not for large ones.

To allow for the potential impact of ownership structure on capacity, we conduct the analysis separately on the basis of two alternative assumptions about the effects of insurance groups on capacity. The first analysis is based on the assumption that the full resources of the group are available to support losses arising from any

---

<sup>10</sup>Insurers are required to report financial data to the NAIC even if they are undergoing severe financial difficulties, are inactive, or are in “runoff mode.” An insurer in runoff mode is engaged in settling existing claims but not writing or renewing policies currently. Such an insurer would not be “on the risk” for projected catastrophes.

<sup>11</sup>Losses rather than premiums were used for the Florida screen because an insurer can remain liable for loss payments in a given year even if it writes no premiums in that year because coverage is provided by policies written in the preceding year (and on which premiums had been paid in the preceding year) that had not yet expired at the beginning of the current year. The results would be nearly identical based on a premium screen.



subsidiary of the group, i.e., the group is considered to act as a single firm. This is equivalent to assuming that groups always rescue failing subsidiaries. The second analysis ignores group affiliations entirely and conducts the analysis as if the members of groups are freestanding, unaffiliated companies. This analysis implicitly assumes that groups never bail out failing subsidiaries. The two analyses can be viewed as giving upper and lower bounds on the capacity of the industry to pay claims.

The losses used in estimating capacity are net losses incurred, defined as direct losses incurred plus losses due to reinsurance assumed minus losses due to reinsurance ceded. Direct losses incurred are defined as losses paid or owed directly to policyholders, while net losses incurred reflect the netting out of reinsurance transactions. Because reinsurance is expected to reduce the standard deviations of individual insurer losses and increase the loss correlations among insurers, our analysis implicitly takes into account the effects of reinsurance on capacity.

#### Parameter Estimation

To estimate capacity for the industry in 1997, we included in the sample all of the companies reported on by the NAIC in 1997 that met our screening criteria for operating viability. However, only a subset of these companies are in the NAIC data base for the full time period covered by the study (1983-1997). Accordingly, we adopt a three-stage procedure for estimating parameters. At the *first stage*, we estimate parameters for the companies that have data for the full time period 1983-1997. We refer to this set of companies as the *full-time series (FTS)* sample. Two sets of parameters are estimated – *raw* parameter estimates calculated directly from the FTS data, and *detrended* estimates based on the residuals from time trend regressions. The reason for computing the detrended estimators is that property-liability insurance losses are subject to a strong positive time trend. The raw estimates of the standard deviation of losses, for example, will capture trend-related growth in losses across years as volatility. However, the trend is highly predictable and insurers can easily plan for it by increasing premiums each year. Differences in losses across years due to this trend effect thus are not unanticipated loss fluctuations and probably should not be included when measuring the effect of catastrophes

and other types of random shocks on insurance market capacity.<sup>12</sup> By measuring capacity using both the raw and detrended parameters, we avoid any possible biases that may arise from relying on only one set of parameter estimates that is subject to time trend bias..

To define the raw and detrended parameters more precisely, let  $L_{it}$  = the observed losses of company  $i$  in year  $t$  and let  $L_t = \sum_i L_{it}$  = total industry losses in year  $t$ . The raw standard deviations are obtained using the following formulas:

$$(12) \quad \hat{\sigma}_i^2 = \frac{1}{T-1} \sum_{t=1}^T (L_{it} - \bar{L}_i)^2 \quad \text{and} \quad \hat{\sigma}^2 = \frac{1}{T-1} \sum_{t=1}^T (L_t - \bar{L})^2$$

where  $\hat{\sigma}_i^2$  = the estimator of the standard deviation of losses for company  $i$ ,  $\hat{\sigma}^2$  = the estimator of the standard deviation of losses for the industry,  $\bar{L}_i = \frac{1}{T} \sum_t L_{it}$ , and  $\bar{L} = \frac{1}{T} \sum_t L_t$ . The correlation coefficient between company  $i$ 's losses and the industry losses is estimated using the following formula:

$$(13) \quad \hat{\rho}_i = \frac{\left(\frac{1}{T-1}\right) \sum_{t=1}^T (L_{it} - \bar{L}_i)(L_t - \bar{L})}{\hat{\sigma}_i \hat{\sigma}}$$

For the lognormal case, estimates of  $\xi_i$  and  $\xi_u$  are obtained from (12) and the estimate of  $\gamma_i$  is obtained from (13), with the quantities  $L_{it}$  and  $L_t$  replaced by  $\ln(L_{it})$  and  $\ln(L_t)$ , respectively.

To obtain the detrended parameter estimates, we first conduct the following regressions for the normal and lognormal cases, respectively:

$$(14) \quad \begin{aligned} L_{it} &= \alpha_{0i} + \alpha_{1i} t + \epsilon_{it} \\ L_t &= \alpha_0 + \alpha_1 t + \epsilon_t \end{aligned}$$

---

<sup>12</sup>It might be argued that insurers also could set aside reserves sufficient to pay for large catastrophic losses on the grounds that the probable maximum loss amounts due to catastrophes are reasonably predictable even though the time of these losses is unpredictable. However, as Jaffee and Russell (1997) point out, accumulation of large catastrophe reserves is not possible in practice due to legal, regulatory, accounting, and tax rules that constrain the ability of insurers to accumulate reserves for events that have not yet taken place.

$$\begin{aligned}
 \ln(L_{it}) &= \beta_{0i} + \beta_{1i}t + \omega_{it} \\
 \ln(L_i) &= \beta_0 + \beta_1t + \omega_i
 \end{aligned}
 \tag{15}$$

Detrended estimates of  $\delta_i^2$  and  $\delta^2$  are obtained by applying the formulas in (12) to the estimated values of residuals  $\epsilon_{it}$  and  $\epsilon_i$ , respectively, from (14); and the detrended estimate of  $\rho_i$  by applying (13) to the estimated residual series  $\epsilon_{it}$  and  $\epsilon_i$  from (14). Detrended parameter estimates for the lognormal case are obtained similarly, using the estimated residuals from (15).

The final parameters to be estimated are the means,  $\mu_i$  and  $\mu_L$ , for the normal case, and the location parameters,  $v_i$  and  $v_L$ , for the lognormal case. Because we are estimating capacity for 1997, we set  $\mu_i$  and  $\mu_L$  equal, respectively, to company  $i$ 's and the total industry losses incurred for 1997. This implicitly assumes that the companies' net premiums for the year are equal to incurred losses. Although this is not precisely correct, it is a good approximation, especially in view of the fact that there were no major catastrophes during the year. As a robustness check, we also used fitted values from the regression time trend lines for 1997. The results were virtually the same using the actual and fitted losses to represent  $\mu_i$  and  $\mu_L$ . The lognormal parameters were estimated so that application of the formula for the mean of the lognormal distribution would reproduce actual losses for 1997. E.g., for company  $i$ ,  $\phi_i = \ln(L_i) - \delta_i^2/2$ . Again, using the trended loss value for 1997 produced virtually identical results.

In the second stage of our parameter estimation procedure we estimate regression models using the FTS sample with the estimated parameters as dependent variables and company financial characteristics as independent variables. The rationale for the regression analysis is twofold: First, the estimated parameter values for some insurers are likely to reflect non-recurring financial shocks leading to unusually high or low estimated parameters. Such parameters are likely to be non-representative of the actual parameters affecting these insurers in future periods. By using the fitted values of parameters from the regression models in place of the parameter

values estimated in stage one of the analysis, we are thus able to smooth the parameter series by tapering the extreme observations. The second, and equally important, reason for conducting the regression analysis is that the regression models can be used to provide parameter estimates for firms that are not in the data base for a sufficiently long period to permit the reliable estimation of stage one parameter values. Parameters for these companies can be estimated by inserting their 1997 financial data into the regression models. Estimation of parameters for this set of companies (called *non-full time series (NFTS) companies*), by obtaining fitted values from the regression models, is the third stage in the parameter estimation process. By conducting the third stage of the analysis we are able to include the maximum number of insurers in our 1997 sample and thus to obtain a comprehensive estimate of industry capacity.

#### 4. Empirical Results

The capacity estimation process was conducted both for national companies and Florida companies. The estimation proceeds by calculating the response function using equation (9) for the normal case and equation (11) for the lognormal case. The response functions give the expected payout for each insurer as a function of its parameters and the total industry loss  $L$ . By varying  $L$ , we generate expected payments for each company for a range of industry losses, starting with a value of  $L$  approximately equal to industry expected losses (nationally and in Florida, respectively) and increasing to the point where  $L$  is equal to total industry resources. In addition to the expected loss payments by company for each value of  $L$ , the analysis also determines whether a company becomes insolvent (if its loss payment, conditional on  $L$ , exceeds its premiums and equity capital). For insolvent firms the total payment is capped at the sum of premiums plus equity capital. A number of supporting statistics can be computed from the response function output, including industry efficiency, the percentage of total catastrophe losses paid for events of various magnitudes, and the number of insolvencies.

As mentioned above, we conduct the estimation for two definitions of the industry in terms of recognizing the presence of insurance groups. The first definition is based on the assumption that each insurance group acts as if it were a single firm. Based on this definition, the industry is defined as consisting of groups and unaffiliated single insurers. We refer to this version of the industry as the *or group* sample. The second

definition of the industry is based on the assumption that companies that are members of insurance group operate independently. This version of the industry is referred to as the company sample.

### Summary Statistics

Summary statistics on losses and equity capital, the two most important determinants of industry capacity, are shown in Table 1. Losses and equity are shown for both the Florida sample and the national sample. The Florida figures are the countrywide totals of losses and equity for insurers doing business in Florida, rather than the Florida business of these companies, based on the rationale that the total resources of the company are potentially available to pay losses from Florida catastrophes rather than just the resources generated from Florida operations. The national sample captures  $xxd$  percent of industry losses and 96.6 percent of industry equity, and thus provides an excellent representation of the industry as a whole. Companies doing business in Florida account for  $xxd$  percent of total industry losses and 79.9 percent of industry equity.

Average values of the raw and detrended parameter estimates are shown in Table 2. As expected detrending significantly reduces the magnitudes of loss standard deviations, correlations between company and industry losses, and correlations between the logs of company losses and the logs of industry losses (the  $\rho$  parameters). Recall that the response functions are decreasing in the insurer's loss standard deviation and increasing in the correlation between the insurer loss and the industry loss. Because detrending leads to large reductions in the correlations than in the standard deviations, we expect the estimated loss payments to be lower for the detrended parameter estimates than for the raw parameter estimates.

The standard deviation estimates tend to be larger for the company sample than for the group sample in both the raw and detrended cases, reflecting the smoothing effect of intragroup reinsurance transactions. The raw estimates of the correlation coefficients and  $\rho$  statistics are somewhat larger for the group sample than for the company sample (in both the national and Florida cases), as expected if intra-group reinsurance transactions tend to increase the covariability of the loss series. However, the detrended correlation coefficient and  $\rho$  statistics are lower for the group sample than for all company sample. Thus, after removal of the time

ward, there is less covariability among firms in the group sample than in the company sample.

#### **Industry Capacity: The National Sample**

The response functions for the national sample are shown in Figure 2. The figure shows the estimated amounts that would be paid for industry losses ranging from \$200 billion to \$500 billion. These limits were chosen because total losses and loss adjustment expenses for the U.S. property-liability insurance industry in 1997 were approximately \$200 billion and the total equity capital was approximately \$300 billion. Thus, the response curve ranges from the industry's actual loss up to the industry's total resources. Four response curves are shown in the figure, based on (a) raw parameters for the group sample, (b) detrended parameters for the group sample, (c) raw parameters for the company sample, and (d) detrended parameters for the company sample.

The estimated response curves are expected to follow certain ordering relationships, based on option pricing theory and the assumption regarding the exercise of the default option for failing insurers that are members of groups. Larger payments are expected when raw parameter estimates are used rather than detrended parameter estimates. The rationale is that removal of the time trend leads to a larger reduction in the correlation coefficients than in the standard deviations (see Table 2). Because the response function values are positively related to the correlation coefficient and negatively related to the standard deviation, the detrended parameters give lower estimated expected payments. Secondly, expected payments for the group and unaffiliated company sample are expected to be higher than payments using the all company sample, holding constant the parameters used in the estimation. That is, for the raw parameter estimates, the estimated payments for the group sample should be larger than the payment for the company sample, and likewise for the detrended parameter estimates. In the group sample, if a company that is a group member exhausts its resources, payments continue to be made from the resources of other insurers that are members of the group until the group's resources are exhausted. However, in the company sample, the failure of a company does not trigger additional payments from members of the same group, because group relationships are ignored in this estimation.

The expected relationships are borne out in the estimated response curves shown in Figure 2. The largest estimated payments are obtained using the raw parameter estimates for groups, followed by the estimates based

on the raw parameters estimates for companies, the detrended parameter estimates for groups, and the detrended parameter estimates for companies. Generally, a high proportion of total losses are paid for industry losses near to the expected value of \$200 billion and ranging up to about \$300 billion. Above that level, noticeable gaps begin to appear between the industry loss and the estimated amounts paid.

The estimated efficiencies for the national sample are shown in Figure 3. Recall that efficiency is defined as the ratio of the area below the curved lines in Figure 2 to the total area represented by the triangle bordered by the 100 percent payment line and the horizontal axis in Figure 2. Obviously, the efficiencies will differ depending upon the value of industry loss used as the starting or attachment point. Accordingly, Figure 3 shows capacity for various starting (attachment) points ranging from \$200 to \$500 billion. The efficiencies are inversely related to the attachment points. For an attachment point of \$200 billion, the efficiency estimates range from 91 percent based on raw parameters for the group sample to about 78 percent based on detrended parameter estimates for the company sample. For the highest attachment points, efficiencies range from about 80 percent based on raw parameters for the group sample to about 65 percent based on detrended parameters for the company sample.

The response function analysis also produces estimates of the percentage of losses that would be paid for catastrophes of different sizes. These percentages are shown in Figure 4. For relatively small catastrophes, the industry would be able to pay very high percentages of the loss. E.g., for a \$20 billion catastrophe, our estimates indicate that the industry would be able to pay at least 98.6 percent of the loss. The percentages that would be paid for larger losses decline at an increasing rate. For example, using the detrended parameter estimates, for a catastrophic loss of \$100 billion the industry would be able to pay about 96.4 percent of the loss based on the group sample and 92.8 percent based on the company sample. For a \$200 billion catastrophe, the industry would pay between 84.0 percent based on the group sample and 78.6 percent based on the company sample.

The significant capacity of the industry to respond to catastrophes in the range of losses represented by Hurricane Andrew and the Northridge earthquake is primarily due to an increase in the relative capitalization of

the industry over the past few years. The ratio of premiums to surplus, a commonly used leverage ratio in the insurance industry, was 1.4 in 1991, prior to Andrew, but had declined to 0.9 in 1997. The increase in capitalization reflects in part the strong investment performance of recent years but also reflects increasing concern about catastrophes in the industry as well as the introduction of risk-based capital regulations in 1995.

We conduct an additional analysis to determine the impact on capacity of the increase in capitalization levels in the industry since 1991. A gauge of the capitalization increase that is more consistent with our model than the premiums to surplus ratio is the ratio of equity capital to losses and loss adjustment expenses incurred (hereafter referred to as losses incurred). In 1991, the ratio of equity capital to losses incurred was \$0.88, while in 1997 the ratio was \$1.56. We recalculated the 1997 capacity of the industry after reducing equity capital proportionately for the firms included in our sample so that the ratio of 1997 capital to losses incurred was the same as in 1991, i.e., \$0.88. The results are presented in Figure 5, which plots the expected company and group payments for catastrophes of various sizes, based on 1991 and 1997 capitalization levels. In order to reduce the number of curves on the chart and focus on what we consider the most realistic results, Figure 5 includes only the capacity estimates based on detrended parameter values.

Figure 5 reveals a dramatic increase in industry capacity to bear catastrophic risk between 1991 and 1997. Focusing on the detrended company loss estimates, the industry would be able to pay 98.6 percent of a \$20 billion catastrophe based on 1997 capitalization levels but would be able to pay only 94.5 percent of a \$20 billion catastrophe based on 1991 capitalization. The results are even more dramatic for larger catastrophes. For a \$100 billion catastrophe, again based on detrended company loss estimates, the industry could pay 92.8 percent based on 1997 capitalization but only 79.6 percent based on 1991 capitalization. For a \$200 billion catastrophe, the industry could pay 78.6 percent based on 1997 capitalization but only 56.4 percent based on 1991 capitalization. The capacity of the industry, even for catastrophes in the \$100 billion range, is clearly much larger in 1997 than it was prior to Andrew and Northridge.

However, even at 1997 capitalization levels, catastrophes in the \$100 billion range would disrupt the market by causing a significant number of insolvencies. For example, a \$100 billion catastrophe is projected to



cause 30 insolvencies based on the detrended parameter estimates for the group sample and 136 insolvencies based on the detrended parameters for the company sample. The comparable numbers of insolvencies at 1991 capitalization levels would have been 108 groups and 216 companies.

#### **Industry Capacity: The Florida Sample**

The response function for the Florida sample is shown in Figure 6. Because the number of insurers operating in Florida is smaller than the number operating nationally, the amount of resources available to pay claims in Florida is commensurately reduced. This can be seen more clearly from the efficiencies plotted in Figure 7. At an attachment point of \$200 billion, the Florida efficiency based on raw parameter estimates for the group sample is about 85 percent, compared to 91 percent at the same attachment point for the national case. Based on detrended parameter estimates for the company sample, the efficiency at the \$200 billion attachment point is 72 percent in Florida, compared to 78 percent nationally.

The estimated Florida payments for catastrophic losses of various sizes are shown in Figure 8 for the detrended parameter estimates at both 1997 and 1991 capitalization levels. As with the national sample, the capacity of the industry to respond to moderate catastrophes appears to be adequate both at 1997 and 1991 capitalizations. For a catastrophe of \$20 billion, the expected payment for the group sample at 1997 capitalization levels would be 99.4 percent, compared to 97.9 percent at 1991 capitalization. The comparable figures for companies are 98.6 percent and 94.4 percent, respectively. Capacity in 1997 also appears to be reasonably adequate for a catastrophe of \$100 billion. The expected payment for groups would be 94.2 percent and the payment for companies would be 89.7 percent. At 1991 capitalization levels, on the other hand, the capacity of the industry to finance a \$100 billion catastrophe was much lower – 77.5 percent payment by groups and only 72.2 percent by companies. The principal finding is that the capacity of the industry increased dramatically between 1991 and 1997 and now is adequate to bear catastrophes in the range of the projected “Big One” (e.g., \$100 billion). However, such a catastrophe would still be disruptive to the insurance market because it would be projected to cause the failure of 34 companies and 10 groups.

#### **Regression Models For Parameter Estimation**

Finally, we provide examples of the regression models used in estimating the parameters for the companies in the market in 1997 that did not have data for the full time series covered by the study (the *non-full time series (NFTS) companies*). Recall that the procedure for parameter estimation is to estimate regression models with the parameters of the FTS companies as dependent variables and various financial characteristics of the companies as independent variables. The parameters for the NFTS companies are estimated by inserting the financial characteristics of these firms into the equation to obtain fitted values to be used in the capacity estimation model. For consistency and to smooth out unusually large or small values of the FTS parameters obtained directly from the data, fitted values of the parameters of the FTS companies are also obtained and used in the capacity estimation. The fitted values of both the NFTS and the FTS parameters are based on 1997 financial data.

The regression models are based on the underlying theoretical principle that insurers seek to maximize returns for a given level of risk, i.e., are attempting to achieve an efficient rate of return on equity in relationship to the risks they bear (see Cummins and Sommer, 1996). Insurers may have a target level of overall risk for a number of reasons. However, there are two primary explanations for having a risk target: (1) For financial firms, the firms creditors are also its customers. E.g., the primary liabilities (debt capital) of property-liability insurers consist of policy reserves, which constitute funds held to pay policyholder claims (Merton and Perrold, 1993). Because the purpose of insurance is likely to be subverted if the debt claims are overly risky, insurers are likely to incur a product market penalty from taking excessive risk, providing one important rationale for having a risk target. (2) Insurers are subject to rigorous solvency regulation that has included risk-based capital requirements since 1994. The risk-based capital rules subject insurers to increasingly restrictive regulations if capital declines below a specified level. This regulatory restriction imposes costs on insurers that most companies try to avoid by holding capital significantly in excess of the amounts required by the risk-based capital standards. Thus, even if there were no product market penalty for being too risky, insurers would still have an incentive to maintain adequate financial safety to avoid regulatory costs (Cummins, Harrington, and Niehaus, 1994).

We also argue that there is a range of insurers in the market in terms of overall firm risk. Some insurers

seek to be high cost, low risk providers to serve the needs of relatively risk averse buyers, whereas other insurers offer a lower cost, higher risk product to appeal to buyers with lower risk aversion. In effect, insurance is priced like risky corporate debt, with the price of coverage inversely related to the degree of default risk. Thus, we may observe insurers that take low (high) underwriting risk and low (high) financial risk to appeal to different segments of the product market.

Because both the penalty for risky debt and the regulatory risk-based capital levels are primarily driven by the standard deviations of losses and investment returns, the regression examples we provide are those with the standard deviation of losses as the dependent variable. The regression models with the raw standard deviations of losses as dependent variables are presented in Table 3. Consistent with the hypothesis that insurers with low (high) underwriting risk also may take less (more) financial risk, the coefficient of the equity capital to assets ratio is inversely related to the standard deviation of losses. In addition, we find that the standard deviation is directly related to the return on assets, suggesting that insurers that are willing to take higher risk in their asset portfolios also take more underwriting risk. The ratio of net income to net premiums written is inversely related to the loss standard deviation in three of the four equations shown in Table 3. This result is consistent with the hypothesis that insurance is priced like risky debt, accounting for the inverse relationship between net income and underwriting risk. The regressions also show a positive relationship between the ratio of reinsurance receivables to assets and underwriting risk. This is closely monitored by regulators because higher levels of reinsurance receivables may indicate that the firm is placing excessive reliance on reinsurance from financially vulnerable reinsurers that are relatively slow in paying claims. Insurers willing to deal with risky reinsurers also may have a tendency to take more underwriting risk.

Two variables are included to measure the effects of size on risk taking. The log of net losses incurred is inversely related to the standard deviation of losses. This finding is consistent with the well known result that insurers with larger underwriting portfolios achieve better diversification and thus have relatively less idiosyncratic risk than smaller insurers. The log of equity capital has a positive coefficient in the regression equations. The coefficient on this variable is consistent with the argument that larger firms tend to take more

risk, because of the better diversification achieved in their underwriting portfolios.

The proportion of an insurer's portfolio held in stocks is inversely related to underwriting risk. However, this variable is significant in only two of the four equations presented in Table 3, for national companies and groups. This variable would seem to suggest that insurers trade off investment and underwriting risk, contrary to the interpretation of some of the other variables. A possible interpretation of this result is that insurers invest in stocks in part because of their relatively favorable tax treatment relative to taxable bonds. Insurers that are more concerned about tax management are likely to be operating in the convex segment of the income tax schedule and also have an incentive to reduce underwriting risk to lower expected tax payments (Cummins, Phillips, and Smith, 1996).

### 5. Conclusions

In this article, we conduct a theoretical and empirical analysis of the capacity of the U.S. property-liability insurance industry to finance major catastrophic property losses. The topic is important because catastrophic events such as the Northridge earthquake and Hurricane Andrew have raised questions about the ability of the insurance industry to respond to the "Big One," usually defined as a hurricane or earthquake in the \$100 billion range. At first glance, the U.S. property-liability insurance industry, with equity capital of more than \$300 billion, should be able to sustain a loss of this magnitude. However, the reality could be different; depending on the distribution of damage and the spread of coverage as well as the correlations between insurer losses and industry losses. Thus, the prospect of a mega catastrophe brings the real threat of widespread insurance failures and unpaid insurance claims.

Our theoretical analysis takes as its starting point the well-known article by Borch (1962), which develops a theorem similar to the capital asset pricing model for reinsurance markets. Borch's theorem shows that the Pareto optimal result in a market characterized by risk averse insurers is for each insurer to hold a proportion of the "market portfolio" of insurance contracts. Each insurer pays a proportion of total industry losses; and the industry behaves as a single firm, paying 100 percent of losses up to the point where industry net premiums and equity are exhausted. Borch's theorem gives rise to a natural definition of industry capacity as

the amount of industry resources that are deliverable conditional on an industry loss of a given size.

In our theoretical analysis, we show that the necessary condition for industry capacity to be maximized is that all insurers hold a proportionate share of the industry underwriting portfolio. The sufficient condition for capacity maximization, given a level of total resources in the industry, is for all insurers to hold a net of reinsurance underwriting portfolio which is perfectly correlated with aggregate industry losses. Based on these theoretical results, we derive an option-like model of insurer responses to catastrophes, leading to an insurer response-function where the total payout, conditional on total industry losses, is a function of the industry and company expected losses, industry and company standard deviations of losses, company net worth, and the correlation between industry and company losses. The industry response function is obtained by summing the company response functions, giving the capacity of the industry to respond to losses of various magnitudes.

Based on our theoretical model, we utilize 1997 insurer financial statement data to estimate the capacity of the industry to respond to catastrophic losses. Two samples of insurers are utilized – a national sample, to measure the capacity of the industry as a whole to respond to a national event, and a Florida sample, to measure the capacity of the industry to respond to a Florida hurricane. In the estimation, we recognize that many insurers are organized in the form of insurance groups, where several insurers operate under common ownership. Insurance groups hold a valuable option, i.e., the option to allow financially vulnerable group members to fail. Accordingly, we estimate capacity under two polar assumptions about the behavior of groups: (a) that groups always bail out failing subsidiaries, so that each group operates as a single firm, and (b) that groups never bail out failing subsidiaries, so that members of groups operate independently. These two assumptions lead to upper and lower bounds, respectively, on the capacity of the industry to respond to catastrophic loss.

The empirical analysis estimates the capacity of the industry to bear losses ranging from the expected value of loss up to a loss equal to total company resources. We develop a measure of industry *efficiency* equal to the difference between the loss that would be paid if the industry acts as a single firm and the actual estimated payment based on our option model. The results indicate that national industry efficiency ranges from about 78 to 85 percent, based on catastrophe losses ranging from zero to \$300 billion, and from 70 to 77 percent, based

on catastrophe losses ranging from \$200 to \$300 billion. The industry has more than adequate capacity to pay for catastrophes of moderate size. E.g., based on both the national and Florida samples, the industry could pay at least 98.6 percent of a \$20 billion catastrophe. For a catastrophe of \$100 billion, the industry could pay at least 92.8 percent. However, even if most losses would be paid for an event of this magnitude, a significant number of insolvencies would occur, disrupting the normal functioning of the insurance market, not only for property insurance but also for other coverages.

We also compare the capacity of the industry to respond to catastrophic losses based on 1997 capitalization levels with its capacity based on 1991 capitalization levels. The comparison is motivated by the sharp increase in capitalization following Hurricane Andrew and the Northridge earthquake. In 1991, the industry had \$0.88 in equity capital per dollar of incurred losses, whereas in 1997 this ratio had increased to \$1.56. To compare 1991 and 1997, we proportionately reduce the capital of the insurers in our sample to achieve an industry-wide capital-to-loss ratio of \$0.88 in 1997. The results indicate a dramatic increase in capacity between 1991 and 1997. For a catastrophe of \$100 billion, our lower bound estimate of industry capacity in 1991 is only 79.6 percent, based on the national sample, compared to 92.8 percent in 1997. For the Florida sample, we estimate that insurers could have paid at least 72.2 percent of a \$100 billion catastrophe in 1991 and 89.7 percent in 1997. Thus, the industry is clearly much better capitalized now than it was prior to Andrew.

The relatively high capacity of the industry at the present time has significant implications for insurance and capital markets as well as for public policy regarding the financing of catastrophic risk. It does not appear that the gaps in catastrophic risk financing are presently sufficient to justify government intervention in private insurance markets in the form of Federally sponsored catastrophe reinsurance. However, even though the industry could adequately fund the "Big One," if defined as a catastrophe in the range of \$100 billion, doing so would disrupt the functioning of insurance markets and cause price increases for all types of property-liability insurance. Thus, it appears that there is still a gap in capacity that provides a role for privately and publicly traded catastrophic loss derivative contracts. Accordingly, both the state and Federal governments should focus on removing regulatory barriers to the further development of private capital market solutions to the financing of large catastrophes. Capital market solutions thus are needed both to shore up industry capacity and to reduce the societal costs of dealing with catastrophic risk.

## References

- Borch, K. 1962, Equilibrium in a Reinsurance Market, *Econometrica* 30: 424-444.
- Cummins, J. David and Patricia M. Danzon, 1997, "Price Shocks and Capital Flows in Liability Insurance," *Journal of Financial Intermediation* 6: 3-38.
- Cummins, J. David and Francois Outreville, 1987, "An International Analysis of Underwriting Cycles," *Journal of Risk and Insurance* 54:
- Cummins, J. David, Christopher M. Lewis, and Richard D. Phillips, 1999, "Pricing Excess of Loss Reinsurance Contracts Against Catastrophic Loss," in Kenneth Froot, ed., *The Financing of Catastrophe Risk* (Chicago: The University of Chicago Press.
- Cummins, J. David and David Sommer, 1996, "Capital and Risk in Property-Liability Insurance Markets," *Journal of Banking and Finance* 20 (1996): 1069-1092.
- Doherty, Neil A. and Seha Tinic, 1981, "A Note on Reinsurance under Conditions of Capital Market Equilibrium", *Journal of Finance*, 36, 949-953.
- Easterbrook, Frank H. and Daniel R. Fischel. 1985. "Limited Liability and the Corporation." *University of Chicago Law Review* 52: 89- 117
- Hogg, Robert V. and Allen T. Craig, 1995, *Introduction to Mathematical Statistics*, 5<sup>th</sup> ed. (Upper Saddle River, NJ: Prentice-Hall).
- Froot Kenneth A. and Paul J. G. O'Connell, 1996 "The Pricing of U.S. Catastrophe Reinsurance," in Kenneth Froot, ed., *The Financing of Catastrophe Risk* (Chicago: The University of Chicago Press .
- Froot, Kenneth, David Scharfstein, and Jeremy Stein, 1993, "Risk Management: Co-ordinating Investment and Financing Problems," *Journal of Finance*, 48, 1629-1658.
- Guy Carpenter, 1998, "1998 Review: United States Property Catastrophe Programs," *Guy Carpenter's Monitor* (New York).
- Jaffee, Dwight M. and Thomas Russell, 1997, "Catastrophe Insurance, Capital Markets, and Uninsurable Risks," *Journal of Risk and Insurance* 64: 205-30.
- Lewis, Christopher M. and Kevin C. Murdock, 1996, "The Role of Government Contracts in Discretionary Reinsurance Markets for Natural Disasters," *Journal of Risk and Insurance* 63: 567-597.
- Merton, Robert and Andre Perrold, 1993, "The Theory of Risk Capital in Financial Firms," *Journal of Applied Corporate Finance*.
- Myers, Stewart C. 1977, "Determinants of Corporate Borrowing", *Journal of Financial Economics*, 5, 147-175
- SwissRe, 1997, "Too Little Reinsurance of Natural Disasters in Many Markets," *Sigma* 7: 3-22.
- Winkler, Robert L., Gary M. Goodman, and Robert R. Britney, 1972, "The Determination of Partial Moments", *Management Science*, 19, 290-296.

**Table 1**  
**Summary Statistics: Losses and Equity Capital**

Case	1997 Losses	% of Total Industry Losses	1997 Equity	% of Total Industry Equity	Number of Firms
National Net Loss: Groups and Unaffiliated Cos	201,905,979,763		370,963,421,647	98.6%	1,248
National Net Loss: All Companies	201,905,979,763		370,963,421,647	98.6%	2,256
Florida Net Loss: Groups and Unaffiliated Cos	156,404,436,986		306,981,844,005	79.9%	431
Florida Net Loss: All Companies	156,404,436,986		306,981,844,005	79.9%	898

Note: Equity has not been adjusted for intra-group consolidations. An adjustment for consolidations was made in estimating capacity. Florida losses are the total (countrywide) losses of insurers operating in Florida.

**Table 2**  
**Detrended and Raw Parameter Estimates: Property-Liability Insurance Industry**

Case	DTSigma	DTrho	DTCorr	Mu	Sigma	Averages	
						Rho	Correl
National Net Loss: Groups and Unaffiliated Cos	0.4112	0.3366	0.1751	15.57	0.5188	0.4762	0.4366
National Net Loss: All Companies	0.4203	0.3694	0.1916	15.67	0.5303	0.4724	0.4320
Florida Net Loss: Groups and Unaffiliated Cos	0.4110	0.3429	0.1306	16.97	0.4760	0.5407	0.4921
Florida Net Loss: All Companies	0.4442	0.3668	0.1821	16.71	0.5177	0.5097	0.4683
							898

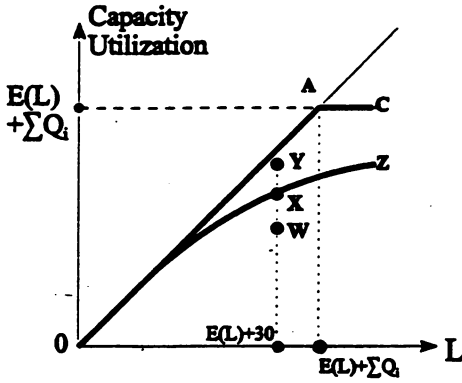


**Table 3**  
**Regression Models of Raw Standard Deviations: Net Losses Incurred**

<b>Variable</b>	<b>Florida Companies</b>	<b>National Companies</b>	<b>Florida Groups</b>	<b>National Groups</b>
<b>Intercept</b>	1.825	1.328	1.297	0.970
	8.047	9.588	5.253	5.367
<b>Equity Capital/Assets</b>	-0.817	-0.800	-0.761	-0.540
	-5.502	-6.358	-3.320	-3.423
<b>Ln(Net Losses Incurred)</b>	-0.296	-0.357	-0.338	-0.355
	-10.126	-20.645	-6.219	-12.040
<b>Ln(Equity Capital)</b>	0.221	0.309	0.293	0.317
	7.124	17.223	5.333	10.467
<b>Return on Assets</b>	0.930	1.852	1.339	3.986
	2.358	6.270	1.155	7.508
<b>Net Income/Net Premiums Written</b>	0.194	-0.183	-0.584	-0.545
	1.711	-3.730	-2.469	-5.405
<b>Reinsurance Accounts Receivable/Assets</b>	1.133	0.722	1.668	0.770
	3.417	3.258	3.335	2.008
<b>Stocks/Assets</b>	-0.036	-0.194	-0.012	-0.269
	-0.313	-2.629	-0.075	-2.222
<b>Adjusted R<sup>2</sup></b>	37.9%	40.1%	33.1%	44.6%
<b>No. of obs.</b>	511	953	172	286

Note: The dependant variable is the standard deviation of losses over the period 1983-1997.

Figure 1: Capacity Utilization



Note: The line  $OAC$  represents maximum capacity utilization. The line  $OZ = E(L) + \sum Q_i - \sum E(T_i | L)$  represents estimated capacity utilization.

Figure 2: Response Functions: National Net Loss

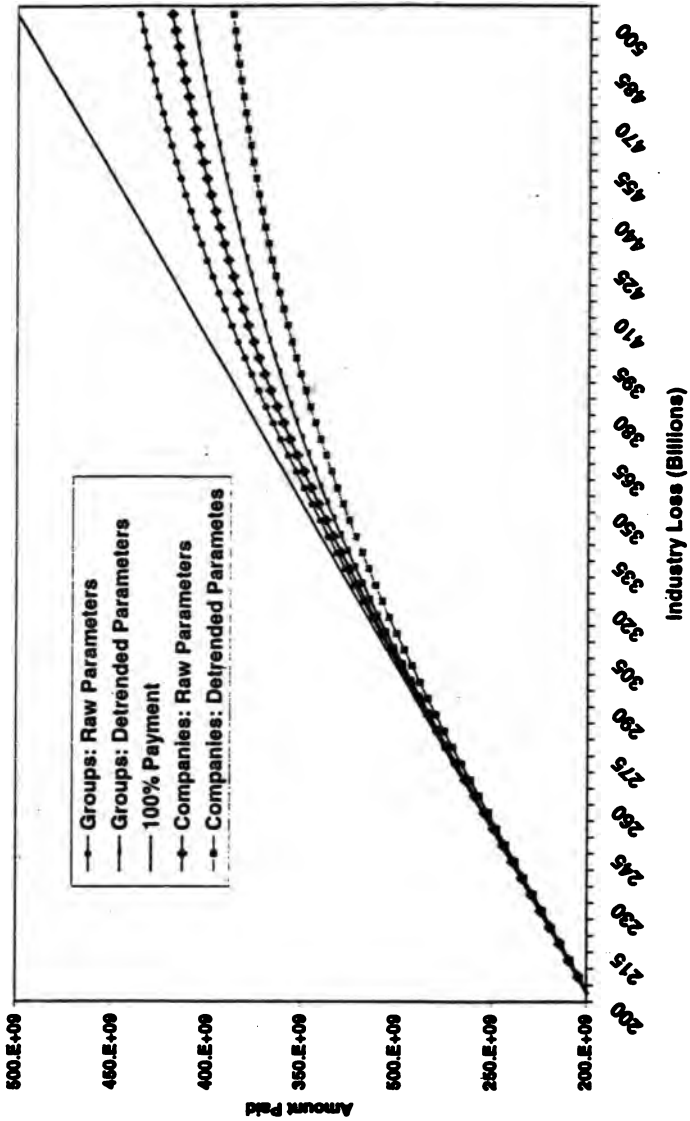


Figure 3: Efficiency - National Net Loss

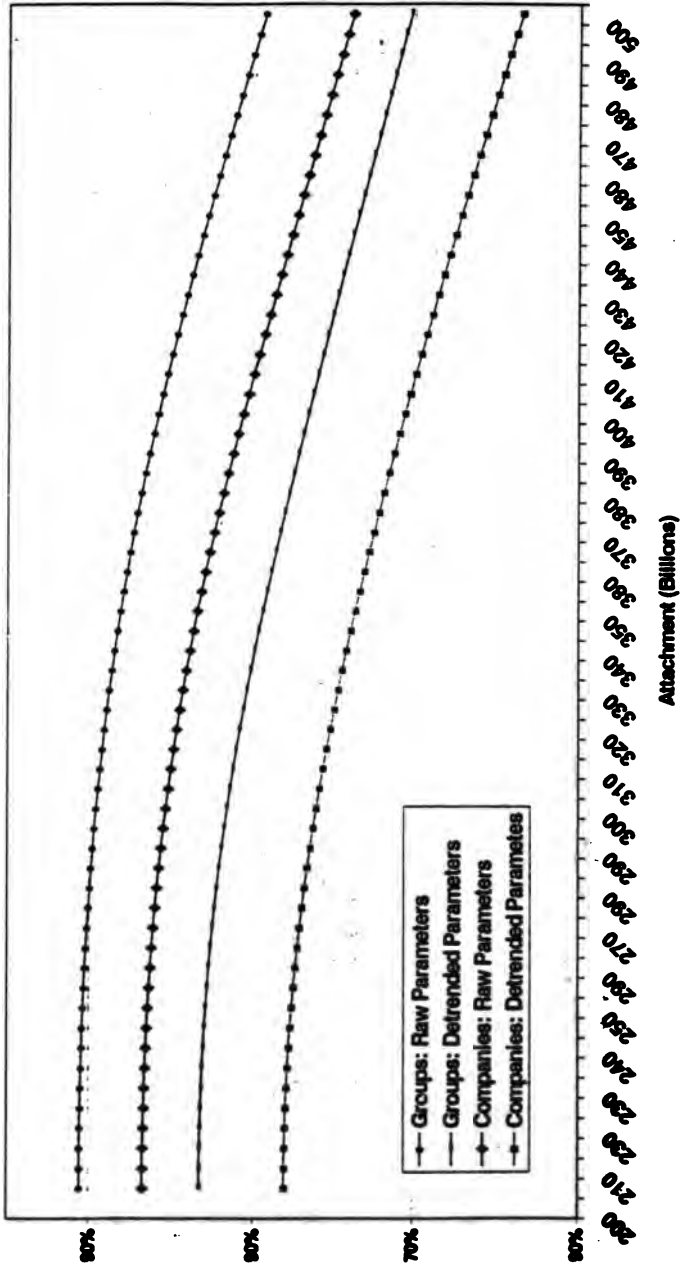


Figure 4: Percent Paid by CAT Loss Size - National Net Loss

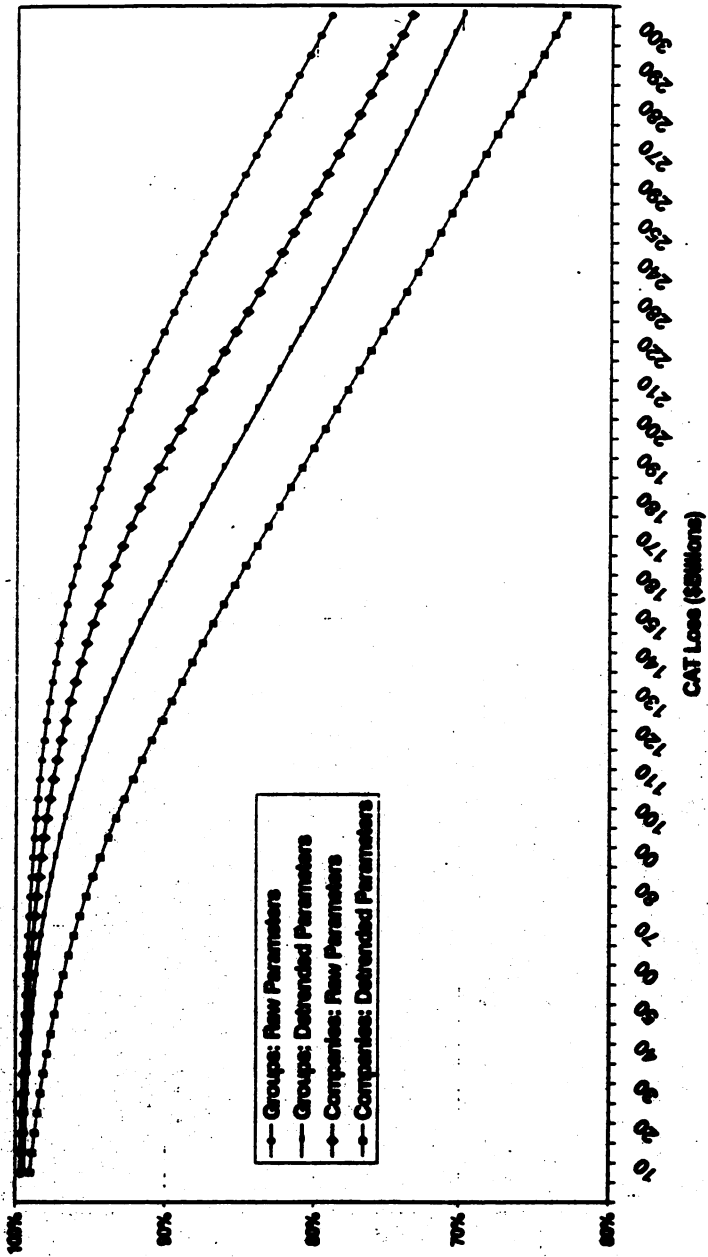


Figure 5: Percent Paid by CAT Loss Size - National Net Loss  
1981 versus 1997 Capitalization

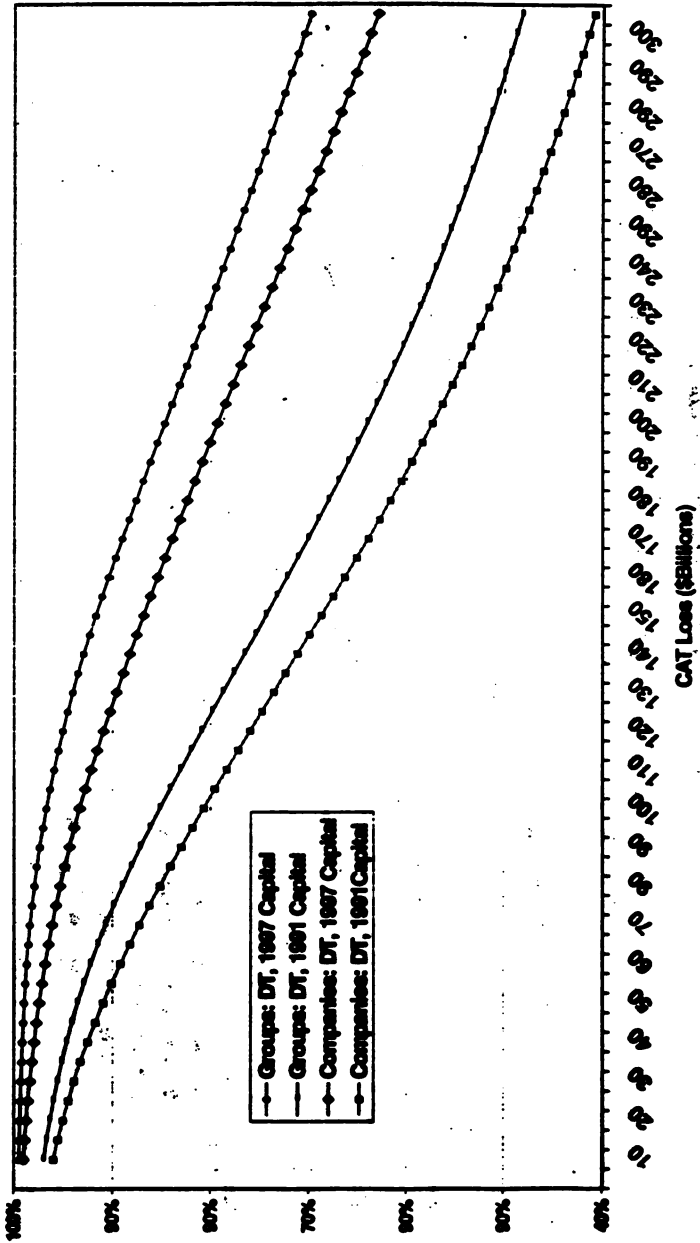
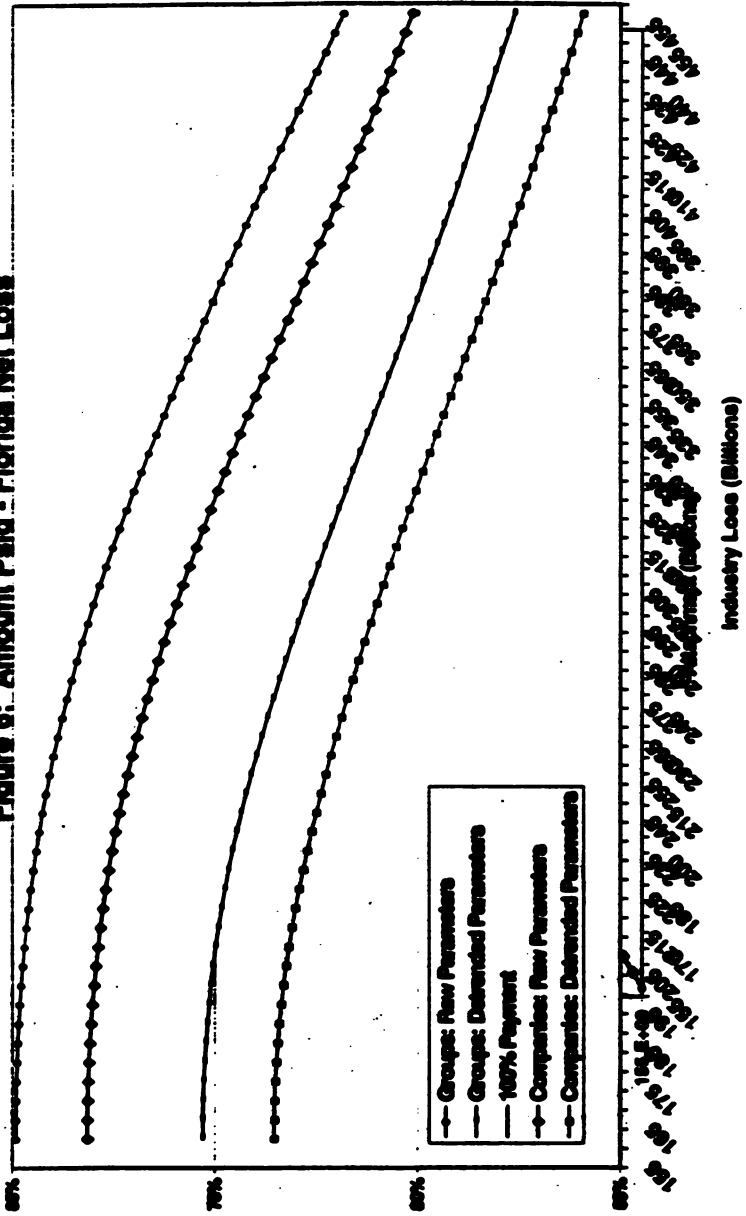
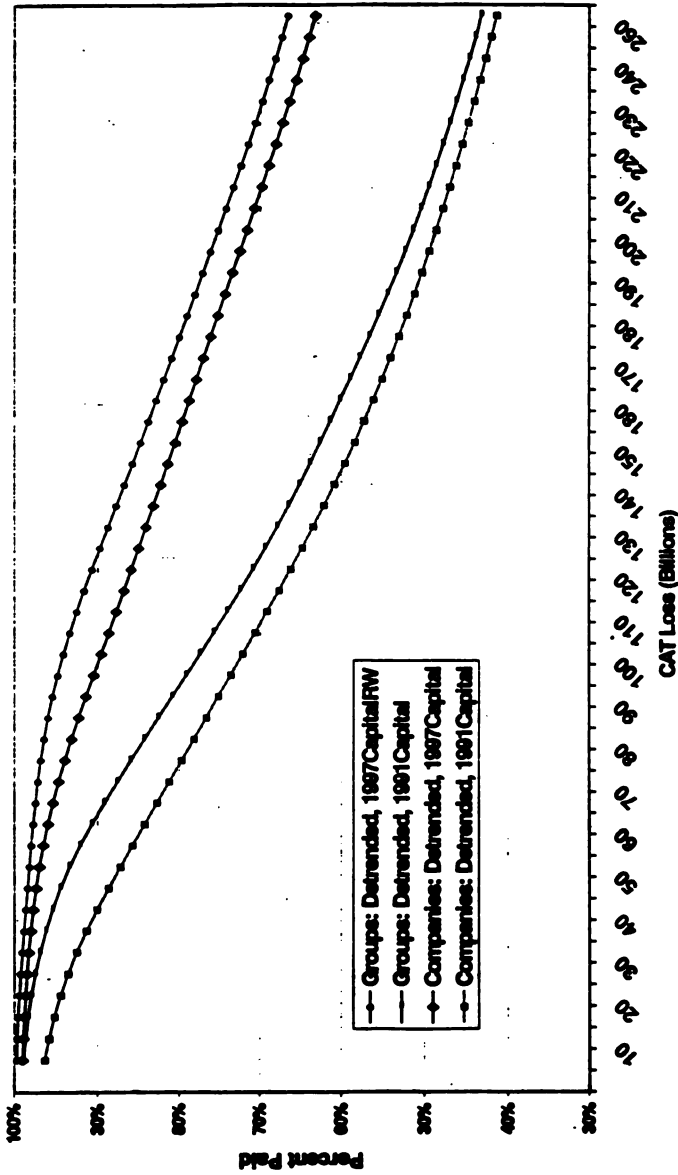


Figure 7: Efficiency - Florida Net Loss

Figure 6: Amount Paid - Florida Net Loss



**Figure 8: Percent Paid by CAT Loss Size - Florida Net Loss  
1991 Versus 1997 Capitalization**





## APPENDIX

## The Model

To estimate the capacity of the industry, we would like to estimate the payments made by individual insurers conditional on the total industry loss. We make use of some general results relating to conditional probability distributions to provide an overview of the problem and then propose specific models based on the normal and lognormal distributions.

In general, let  $L_i$  = the loss paid by company  $i$ , where  $E(L_i) = \mu_i$ ,  $\text{Var}(L_i) = \sigma_i^2$ , and  $i = 1, 2, \dots, N$ , for a sample of  $N$  firms. Define the total losses of the industry as the sum of the losses of the individual companies, i.e.,

$$L = \sum_{i=1}^N L_i \quad (8)$$

where  $L$  = the total losses of the industry. The usual formulas for the mean and variance of a sum of random variables apply, so that

$$E(L) = \sum_{i=1}^N \mu_i \quad (9)$$

$$\text{Var}(L) = \sum_{i=1}^N \sigma_i^2 + 2 \sum_{i < j} \sigma_{ij}$$

where  $\sigma_{ij} = \text{Cov}(L_i, L_j)$ . To conserve parameters and focus on the industry loss, we rewrite the variance of the industry loss as follows:

$$\text{Var}(L) = \sum_{i=1}^N \text{Cov}(L_i, L) = \sum_{i=1}^N \text{Cov}(L_i, \sum_{j=1}^N L_j) \quad (10)$$

The well-known formula for the conditional expected value (see Hogg and Craig, p. 94) can be used to obtain:

$$E(L_i | L) = \mu_i + \frac{\rho_i \sigma_i}{\sigma_L} (L - \mu_L) = \mu_i + \beta_i (L - \mu_L) \quad (11)$$

$$\text{where } \beta_i = \frac{\rho_i \sigma_i}{\sigma_L} (L - \mu_L) = \frac{\text{Cov}(L_i, L)}{\sigma_L^2}$$

Summing over the  $N$  firms in the industry, we find that  $\sum_i E(L_i | L) = L$ , because  $\text{Var}(L) = \sum_i \text{Cov}(L_i, L)$  and  $\mu_L = \sum_i \mu_i$ . Thus, we can use these formulas to allocate any given industry loss among the firms in the sample.

The above results are not distribution dependent, i.e., we did not have to assume that losses follow any particular probability distribution in order to obtain the results. To calculate the capacity of the industry, however, it is helpful to have a distributional assumption. We develop the model under two assumptions: (1) the distribution of the  $L_i$  is multivariate normal and (2) the distribution of the  $L_i$  is multivariate lognormal. We develop the model in general and then specify the formulas for the normal and lognormal cases.

Insurers are assumed to begin the period with premiums,  $P$ , and beginning equity (surplus),  $Q_0$ . The insurer is assumed to pay claims up to the point where these resources are exhausted and to declare bankruptcy and default if the claims exceed its resources. The expected equity of the insurer at the end of the period, conditional on an industry loss of  $L$ , is given by:

$$E(T_i | Q_{i0}, L) = \int_0^{P_i + Q_{i0}} (P_i + S_{i0} - L_i) f(L_i | L) dL_i \quad (12)$$

where  $f(L_i | L)$  = the distribution of the losses of a given insurer ( $L_i$ ), conditional on the losses of the industry,  $L$ .

In the case where the  $L_i$  are jointly normally distributed, the conditional distribution in (5) is given by:

$$f(L_i | L) = \frac{1}{\sqrt{2\pi} \sigma_i \sqrt{1 - \rho_i^2}} e^{-\frac{1}{1 - \rho_i^2} \left\{ \frac{L_i - \mu_i}{\sigma_i} - \rho_i \frac{L - \mu_L}{\sigma_L} \right\}^2} \quad (13)$$

So  $E(L_i | L) = \mu_i + (\rho_i \sigma_i / \sigma_L) (L - \mu_L)$ . Inserting equation (6) into equation (5) and simplifying, we obtain the expression for the expected ending surplus under the assumption of multivariate normality:

$$E(T_i | Q_{i0}, L) = (P + Q_{i0} - m) N\left[\frac{P + Q_{i0} - \mu_{L_i|L}}{\sigma_{L_i|L}}\right] + \sigma_{L_i|L} \frac{1}{\sqrt{2\pi}} e^{-\frac{1}{2} \left\{ \frac{P + Q_{i0} - \mu_{L_i|L}}{\sigma_{L_i|L}} \right\}^2} \quad (14)$$

$$\text{where } \mu_{L_i|L} = \mu_i + \frac{\rho_i \sigma_i}{\sigma_L} (L - \mu_L) \quad \text{and} \quad \sigma_{L_i|L}^2 = \sigma_i^2 (1 - \rho_i^2)$$

$N[\cdot]$  = the standard normal distribution function.

Using an analogous approach for the case where  $L_i$  and  $L$  are jointly lognormal, we obtain:

$$E(T_i | Q_{i0}, L) = (P + Q_{i0}) N(C_i) - e^{D_i} N(C_i - \xi_i \sqrt{1 - \gamma_i^2}) \quad (15)$$

where

$$C_i = \frac{\ln(P + Q_{i0}) - v_i - \frac{\xi_i \gamma_i}{\xi_L} (\ln L - v_L)}{\xi_i \sqrt{1 - \gamma_i^2}} \quad (16)$$

$$D_i = v_i + \frac{\xi_i \gamma_i}{\xi_L} (\ln L - v_L) + \frac{\xi_i^2 (1 - \gamma_i^2)}{2} \quad (17)$$

and  $v_i, v_L$  = the location parameters of the joint lognormal distribution of  $L_i$  and  $L$ ,

$\xi_i, \xi_L$  = the dispersion parameters of the joint lognormal distribution of  $L_i$  and  $L$ , and

$\gamma_i$  = the correlation coefficient between  $\ln(L_i)$  and  $\ln(L)$ .

In the lognormal case, we have the complication that  $L_i$  and  $L$  cannot be jointly lognormal if the  $L_i, i = 1, \dots, N$ , are jointly lognormal, because sums of lognormals are not lognormal. Hence, the formula (equation (8)) is only approximate in this case.

The normal and lognormal models yield estimates of the expected end-of-period surplus of the insurers in the sample. However, our ultimate objective is to estimate the amount of claims paid. The amount of claims paid can easily be estimated using the following relationship:

$$E(L_i | Q_{i0}, L) = P_i + Q_{i0} - E(T_i | Q_{i0}, L) \quad (18)$$

That is, the expected payment equals the resources at the beginning of the period minus the expected amount of surplus at the end of the period.

Mr. Chairman,

I would like to thank you for holding this hearing to further study the capacity of the reinsurance industry and to explore other reinsurance options other than a broad new government program.

While I understand that the private insurance and reinsurance industry currently would face tough challenges should a catastrophic disaster occur, I fear that this condition could be exacerbated following federal involvement in the insurance market. Additionally, I am concerned that government crowding-out of the private insurance market would be create a huge liability for American taxpayers.

My biggest concern is that, under H.R. 21, my constituents in Wisconsin would be cross-subsidizing the residents of Florida or North Carolina or California, who chose to build their homes in areas of higher risk to hurricane or earthquake loss. This already happens at the state level in disaster-prone states and is one of the greatest reasons for the shortage of affordable private insurance in these areas.

At the state level, where private insurance markets are regulated, several states – and usually those most often cited for availability and affordability problems – have mandated that all homeowners buy disaster insurance of some type and that all insurers provide it at a given premium. The homeowners, who choose to build or buy a home on a fault-line or in the path of violent ocean tides, should pay a much higher premium than homeowners who choose to build in safer areas – if realistically allowed to build in the riskier area in the first place. But with government intervention such as price controls or mandated coverage, those with the highest risk no longer pay premiums that correlate with their loss should it occur, while the less-risky homeowners now pay more to help subsidize those who live in high risk areas in order to keep the insurance companies solvent.

As more state mandates are placed on private insurance companies, the insurance companies quit selling in these states, leaving only a few large companies to supply insurance to everybody. With such great exposure, it is no wonder that certain companies are clamoring for a federal backstop. Federal reinsurance would not fix these underlying problems. Before Congress considers a new federal program such as that laid out by H.R. 21, I believe we should look into why we need such a program in the first place.

Over-regulating the insurance market keeps new insurers out of the market that could increase the availability of coverage and take on a share of the catastrophic exposure. By reforming state insurance regulations to encourage greater competition between private insurers, homeowners would have more options in premiums and services and companies would have others selling in the state market sharing their liability.

Further, we should not underestimate the capacity of the private reinsurance market. Recent studies have shown that there is an overabundance of reinsurance

capacity in the United States. According to such studies, there is approximately \$20 billion of catastrophic insurance capacity available per region, per event, not including the reserves of the primary insurance companies.

For every well-intended manipulation of the private insurance market, there are many unintended consequences. I would like to see exploration of private industry solutions exhausted. I believe that solutions exist within the private reinsurance market, and we should encourage their development over government intervention. However, if a solution cannot be found, I would like to see state or regional options investigated before Congress creates a broad federal program. At the very least, I would like to see H.R. 21 incorporate higher triggers to activate a federal response.

I look forward to working with Chairman Leach and Mr. Lazio on this issue.

Thank you.

**EMBARGOED UNTIL 9:30 A.M. EDT**  
**Text as Prepared for Delivery**  
**July 30, 1999**

**DEPUTY SECRETARY OF THE TREASURY STUART EIZENSTAT**  
**HOUSE BANKING AND FINANCIAL SERVICES COMMITTEE**

Chairman Leach, Representative LaFalce, Representative Lazio, Representative Frank, Members of the Committee. Thank you for providing me the opportunity to discuss with you the important issue of disaster insurance.

Let me begin by complimenting Representatives Lazio, McCollum, LaFalce, Frank, and other members of the Committee for the bipartisan leadership they have shown in facilitating the deliberations on this proposed legislation. Your skill, insight, and perseverance will lead to a better legislative outcome than would otherwise have been achievable.

**I. Review of Principles**

That we are again here with you on the issue of disaster insurance demonstrates the grave importance that we all attach to it. Although no piece of legislation can ameliorate the human costs of such disasters, the Administration remains convinced that a well-designed reinsurance program for homeowners' losses could help provide the foundation for communities, individuals, and the private markets on which they depend to make a sound recovery in financial terms. Our approach to this issue reflects the conviction that a policy we adopt prior to a catastrophic event will not only serve the public interest better than one adopted in the immediate aftermath, but also enhance the ability of private insurance markets to cope with the *threat* of loss from such an event.

The characteristics of natural disasters make their risk especially difficult for insurers to handle: they happen only infrequently, but when they do occur, they can be exceedingly expensive. Reflecting this difficulty, prices for disaster reinsurance for homeowner losses can be very high measured in terms of expected losses, and prices can spike -- and markets shrink -- for a considerable period of time following a disaster.

Because of their tremendous capacity for absorbing losses, we view the capital markets,

in which disaster risk increasingly can be bought and sold like many other risks, as a crucial complement to the traditional reinsurance industry. We have closely monitored the development of capital markets. Recent progress encourages us in our belief that insurance securitizations in capital markets will be a significant part of well-functioning markets for disaster risk in the long run. But we are persuaded that a problem still remains in the interim -- while the volume of these securitizations builds. A carefully designed Federal involvement may be able to alleviate this problem.

Three considerations argue for prudent, interim participation of the Federal government in the market for disaster reinsurance. First, the Federal government is uniquely capable of spreading risk across the population and over time. The capacity of the Federal government to gather resources from a wide base for the purpose of meeting short-term contingencies dwarfs that of any single private sector entity. Second, the Federal government would likely bear part of the cost associated with stabilizing distressed insurance markets in a truly cataclysmic event regardless of whether legislation of the type now before the Committee is enacted. Finally, prudent participation at this stage of development may enhance the ability of private markets to deal with these risks.

It is essential that any Federal involvement be guided by a set of common-sense principles. Secretary Summers has defined them in previous testimony to you. Let me enumerate them again.

- Federal involvement *must support, not supplant*, private insurance markets.
  - it must be partial, applying only to true catastrophes that the private market is not capable of handling; and
  - it must be strictly transitional, phasing out as private markets develop.
- Federal involvement *must share, not subsidize* risk
  - Federal involvement should create new capacity to absorb risk, but that involvement must be at *no net cost* to the taxpayer

## II. Where We Are Today

We see the legislation now before the Committee as a generally positive step forward. In our view, the proposed legislation constructively and creatively responds to the difficulty faced by both state funds and private entities in purchasing reinsurance against their large, but low-probability losses on homeowners' insurance. The bill has improved as it has moved through the legislative process. That said, we remain concerned about some aspects of the bill. We have attempted to articulate clearly our concerns with the bill at every stage of the process and to work with staff to explore means of resolving those concerns. We look forward to continuing that

approach, working with Members of the Committee on both sides of the aisle.

Let me now turn to the specifics of the proposed legislation before you. In brief, H.R. 21 would have the Federal government sell excess-of-loss reinsurance to qualifying state funds, and auction industry excess-of-loss contracts to eligible private or state purchasers for losses above certain threshold amounts incurred on residential policies. The bill would establish a Disaster Reinsurance Fund that would receive all premium income and the proceeds of any borrowing done on the program's behalf, and would disburse payments in the event of qualifying disasters. It would establish a Commission for the purpose of advising the Secretary of the Treasury as to the appropriate price for the reinsurance sold to the states as well as the minimum price at which insurance would be provided through the regional auctions.

### III. Outstanding Concerns

We continue to be concerned about several aspects of the proposed legislation. Our concerns are derived from our desire for legislation that addresses the market problem and fulfills our public stewardship responsibility. We know you share that desire.

Let me enumerate the most important of these concerns:

#### Cap

The proposed legislation would cap annual payouts under the program at \$25 billion. The bill provides that, if claims in any one year were to exceed that amount, each claimant would receive a prorated portion of the \$25 billion.

As you know from Secretary Summers' previous testimony, we share your objective of developing a fiscally prudent piece of legislation. Moreover, we believe that a hard limit on the potential draw on the Treasury is an essential component of fiscal prudence. However, as Secretary Summers testified in 1998 and as we explained in communications to Subcommittee staff, after careful study, we have concluded that the cap on annual insurance payouts may not be the best mechanism for limiting the Federal liability. To see why, consider what would happen if a covered event were to occur. In the aftermath of such an event, people and communities in the affected area might be financially devastated, and the insurance industry might be under great financial stress. It would be difficult for the Federal government to withhold payout on claims under this program on the argument that such payout might later need to be pro-rated against claims from another event.

If a second event were to occur within the same insurance year, it is entirely plausible that future Congresses and Administrations would make full payment on all claims stemming from the second event, notwithstanding the requirement to pro-rate. The only alternatives would be either to recall monies that were paid out pursuant to the first event, or impose the full burden of the annual cap on the victims of the second event. Neither alternative seems realistic.



Thus, a real possibility is that the insurance would be priced under the false assumption that the annual cap on payouts would hold, while in practice it would not. In essence, the premium would be set too low. The Federal government and the American taxpayer should not be placed in this position.

We strongly share the motivation that brought this provision into the current draft legislation, but we believe that it is possible to design a more effective mechanism for limiting the Federal liability and ensuring fiscal prudence. One possible approach would involve limiting the amount of insurance to be sold rather than the amount of payout to be made. Briefly, a mechanism along these lines would work as follows: Contracts sold under the legislation would cover 50 percent of any losses above the threshold level that triggers the Federal payout, up to an upper limit corresponding to the dollar amount that would be lost in an event of some more remote probability. For the sake of illustration, one could consider setting the upper limit at the dollar amount corresponding to a one-in-500-year event.

For example, if the 1-in-100 loss in a region were \$12 billion and the 1-in-500 loss were \$48 billion, the Federal liability in the region would be capped at half the difference between \$48 billion and \$12 billion, or \$18 billion, and this loss would occur only if the industry actually purchased all the contracts they were offered.

The aggregate maximum Federal payout could then be computed as the sum of the maximum obligations in each state and region. The preliminary data we have indicates that if the upper limit were set at the dollar amount associated with a one-in-500-year event in each state and region, the maximum Federal liability in any given year would be on the order of \$50 billion. Under this approach, the maximum Federal liability is easily dialed up or down by adjusting the probability associated with the upper limit. The probability of hitting this cap would be extraordinarily small.

Three aspects of this approach are worth emphasizing. First, and most importantly, it would provide a realistic guarantee of fiscal control over the losses that might be sustained under this program. Second, it would have the virtue of providing a natural means of allocating coverage between the two fundamental branches of the program, and — within each branch — among the various states and regions. In the draft legislation as it stands, the mechanism for allocating coverage across states and regions is not spelled out. Third, the dollar figure giving the maximum possible loss under this approach is conceptually different from the dollar amount of the cap embodied in the current draft of the legislation. Put simply, the conceptual difference is this: Under the draft legislation, an undefined amount of insurance would be sold, but the Federal government in some circumstances *ostensibly* would make good on only a part of what was sold. *Under the approach we are proposing, the government would sell only a limited amount of insurance, but, having sold it, would make good on all of it.*

In sum, our objective is to propose an even more effective tool for fiscal control than is contained in the current draft of the legislation. We have held extensive discussions with

committee staff to lay this proposal out for them. The appendix explains our proposal in more detail.

#### Appropriated Payouts

The proposed legislation would require that all payouts from the Fund and borrowings by the Fund be subject to Congressional appropriations.

We believe that all involved in this process intend that, if the program is established, the government should meet its financial obligations under the program, in full. However, the requirement that payouts be subject to appropriation would cast a shadow over the certainty of full payout, and could therefore limit the number of bidders and possibly dampen their aggressiveness in bidding. The net result could be that the Federal government receives less than the value of the risk that it assumes..

The concern can be addressed by striking the requirements for appropriations of payouts and borrowings. This would create the greatest clarity and certainty among all the parties to the contracts, and thereby ensure that the government obtains the most favorable price for the reinsurance provided. And it would bring the provisions of this bill into line with the approach taken under a number of other Federal insurance programs, including deposit insurance, pension guarantees, flood insurance, and crop insurance. Payments for eligible claims under these programs are made from program reserves and receipts and, when necessary, borrowing from the Treasury under authority granted in authorization law, and do not depend on appropriations.

#### Continued Purchase Requirement

The proposed legislation would require a state program participating in the Federal program to continue purchasing reinsurance from the Federal program in the event that the state program were to receive a payout from the Fund that caused the Fund to borrow from the Treasury. Such borrowing would happen if the payout to the state program either caused the balance in the Fund to go below zero or took an already negative balance down further. The state program must continue to purchase the reinsurance until the borrowed funds are repaid.

This provision raises some difficult issues. For one, it could further burden an already stressed state program in the aftermath of an event. Further, there would be the possibility of a scenario, not unlike the one that causes us concern over the annual cap, in which the requirement would be waived. If a state has experienced a huge disaster, and needs to devote scarce resources to promoting recovery, the additional burden of continuing to make premium payments may be viewed as untenable by future Congresses and Administrations, and might therefore be waived. In this case we would have been inadequately compensated for the reinsurance we would have, in fact, provided.

This provision should be eliminated because, like the pro-rating provision, it could place

the Federal government in an extremely difficult position. We could, however, suggest an alternative that could both adhere to our principles and be consistent with the intent of this provision—to give Treasury the option of offering multiple-year, as well as one-year, contracts, if market conditions indicate that such contracts would be appropriate and desirable.

#### IV. Triggers

The threshold “trigger” levels for a Federal payout are an extremely important parameter of the proposed legislation. They must be designed to strike an appropriate balance between two very important considerations. On the one hand, the triggers should not be set so high that the program is irrelevant for either state programs or private participants. On the other hand, as I mentioned at the outset, a key principle for us has been that Federal involvement in this market should not crowd out private sector activity. This program should insure only losses of true catastrophes that the private market is not capable of handling.

Operationally, it would be difficult to strike the right balance between these two considerations. In part, this difficulty reflects the fact that the appropriate trigger level will be a moving target, changing across time and by risk, according to the state of reserves in the traditional reinsurance industry and the state of development of capital markets, among other factors.

We observe in this connection that Congress has wisely chosen to delegate to the Secretary the determination of annual adjustments to the trigger levels, but did not explicitly give the Commission a role in advising the Secretary on this issue. This strikes us as an issue where advice from the Commission would be welcome and constructive. A modified approach that allowed for such a role on the part of the Commission would further make sense because it would more nearly parallel the process outlined for dealing with the annual adjustments to the estimates of expected loss.

Overall, there is no easy answer on the issue of setting the triggers, but it must reflect a sensible balancing of competing considerations. Accordingly, we strongly encourage this Committee and the rest of the Congress to continue in your process of consultation with all interested parties.

#### V. Technical considerations

We want to flag for the Committee’s attention one issue of a more operational nature. In particular, you should be aware that, given the complexity of the undertaking, a considerable length of time will be required to bring the full program, and the required dedicated resources, on line. There will accordingly be an issue with respect to paying start-up costs. There will be a period while the Treasury prepares to offer the program, including developing the appropriate organization, hiring staff, and seeking qualified contractors to define the exposure to loss; and yet no insurance will have been sold. We must be assured of a clear mechanism for funding these

costs. As a practical matter, we could use the proposed borrowing authority to cover these costs, to be repaid from eventual receipts from the sale of disaster reinsurance.

## **VI. Conclusion**

The Clinton Administration has long recognized the importance of improving the nation's ability to deal with natural disasters. While our list of concerns may seem long, all of our suggestions derive from our two core concerns: that relief for insured homeowners not come at the expense of taxpayers, and that any Federal program share risk and support private markets. We believe that we all share a clear recognition of the importance of moving forward. The current proposed legislation provides a sound foundation for progress in this area, and we look forward to working with Members of this Committee, its staff, representatives of industry and of affected communities, and with other stakeholders, to resolve these issues.

# APPENDIX

## CAPPING FEDERAL PAYOUTS

The proposed legislation would cap annual payouts at \$25 billion. The bill provides that, if claims in any one year exceed that amount, each claimant is to receive a prorated portion of the \$25 billion. After careful study, we have concluded that this provision is an imperfect mechanism for limiting the potential draw on the Treasury. As the body of the testimony describes, the proposed cap would place the Federal government in a difficult situation. If claims of more than \$25 billion were to be lodged against the government, future Congresses and Administrations would face enormous pressures to make good on the full amount of those claims, notwithstanding the requirement to prorate.

We believe that an effective mechanism for limiting the Federal liability and ensuring fiscal prudence is an essential feature of fiscally prudent legislation, and we are confident that such a mechanism can be devised. One approach we have been exploring would involve capping the amount of insurance to be sold rather than the amount of payout to be made. Under this approach, the *total* amount of insurance offered to each state would equal 50 percent of the difference between (a) a threshold trigger level (essentially, a "deductible"), and (b) an upper limit loss. The bill sets the threshold trigger level at the greater of (a) the amount that would be lost in a 1-in-100-year event, (b) \$2 billion, and, for existing state programs, the claims paying capacity of the program; the bill also provides for certain transition trigger levels. The upper limit loss could be set similarly at the amount that would be lost in some less probable event, such as a 1-in-500-year event.

- For example, if the 1-in-100-year loss on insured residential property in Missouri were \$4 billion, and the 1-in-500-year loss were \$8 billion, then the total amount of coverage offered to Missouri would be half of the difference between \$8 billion and \$4 billion, or \$2 billion.

Coverage would be allocated between the state programs and the regional auctions in proportion to the share of the industry risk in each state that the state program (if any) covers.

- ***State with 100 percent state program:*** If a state elects to create a state program that, as a matter of policy, reinsures every insurance entity with exposure to residential property losses in the state for all its losses above the deductible, we propose to offer the full state allocation to the state program. Because the full amount of coverage for the state had been offered to the state program, nothing attributable to this state would be offered in a regional auction.
- ***No state program:*** If a state elects not to create a state program, we would attribute the full amount of that state's allocation to the applicable regional auction. If Missouri chose not to establish a state program, we would add \$2 billion in total insurance to the auction of contracts for the region covering Missouri.

- ***State with partial state program:*** A state could create a state program that, as a matter of policy, does not reinsure all residential exposure in the state. For example, the state could allow private insurers operating in the state the option (but not the obligation) of purchasing reinsurance with the state program. If, as a result, the state program bore two-thirds of the aggregate exposure to losses in the state from catastrophes above the threshold trigger, we would offer two-thirds of the state's total allocation to the state program, and would attribute the remaining one-third to the regional auction pertinent to the state in question. If the state in question were either California or Florida, for which we are directed to hold state auctions, the amount available in the auction would simply be the one-third not offered to the state program. If the state in question was covered by a multi-state region, the total amount offered in the regional auction would be incremented by the one-third not offered to the state program. The total amount of insurance offered in a multi-state regional auction would simply be the sum of the obligations that would have been sold to the states, had they been treated as individual entities.

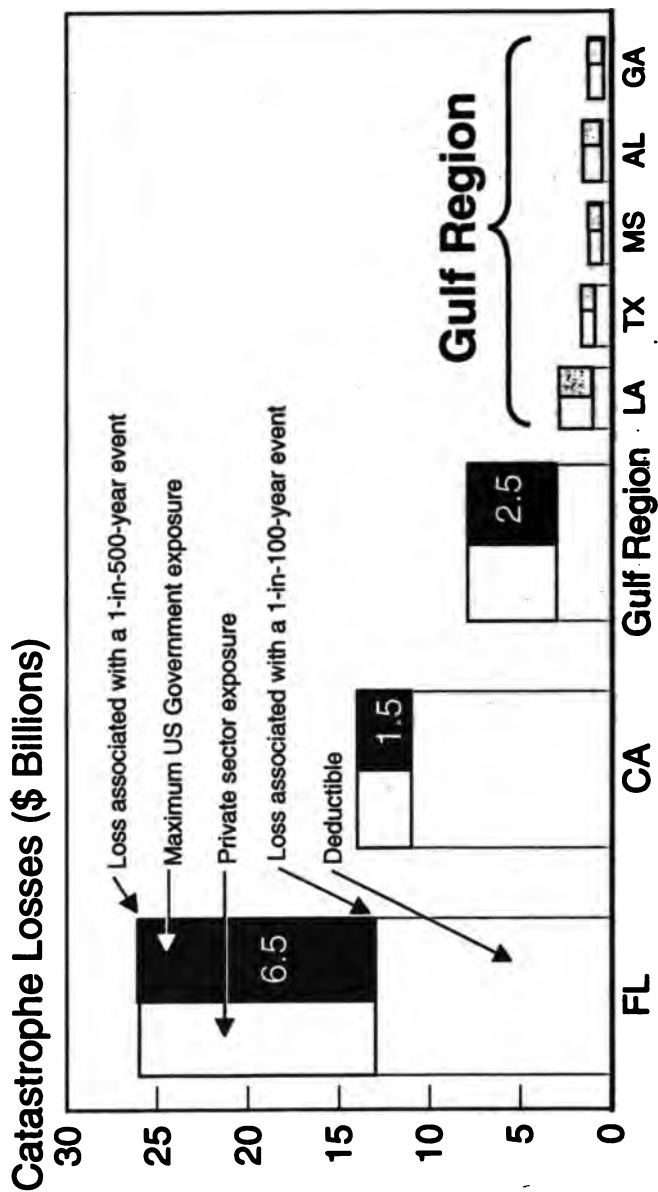
Under this approach, the total Federal exposure would be capped at the sum of the obligations sold to each state and region. If we set the upper limit at the 1-in-500 loss, the rough calculations we have performed suggest that this total could be on the order of \$50 billion. Reducing the upper limit, to, say, the 1-in-400-year loss, would lower the cap on the annual Federal payout. Raising it, to, say, the 1-in-1000-year loss, increases the cap. Of course, the total maximum Federal exposure could be set at any level the political process felt was best. The problem for modelers would be simply to deduce the probability associated with that cap, and hence the allocation of coverage across states and regions.

The probability of hitting this cap would be extraordinarily small; the cap would be hit only if every state and region bought its full allotment of contract protection, and huge events happen to every state in one year that cause the maximum payouts to be made.

An ancillary benefit of the approach sketched here is that it provides a natural method of allocating coverage across states and regions. The legislation as currently drafted does not address that issue.

# Maximum Federal Obligations Based on Reinsurance Offered

## Illustrative Chart and Data Only



## Explanatory Notes

- The legislation as currently drafted seeks to limit the government liability by capping the amount that would be *paid*. Our concern is that this cap might be busted under pressure of multiple disasters.
- Under the alternative proposal summarized here, the government limits its potential liability by capping the amount of insurance offered.
- In the accompanying chart illustrating the alternative approach, the deductible amount is set at the loss associated with a 1-in-100-year event.
- The ceiling amount is set at the loss associated with a 1-in-500-year event.
- The government's maximum exposure in each state is 50 percent of the difference between the ceiling and the deductible; its aggregate maximum exposure is the sum of these amounts across states. A loss of this magnitude would be experienced only if all insurance offered were actually purchased, and an event of sufficient size occurred. The private market remains exposed to the remaining 50 percent.
- The aggregate government exposure can be set in the legislation. Separately, Treasury would adjust the level of the deductible after the first year, taking into account developments in private market capacity and other factors.
- The ceiling amount would follow as an implication of the desired aggregate exposure and the deductible level.



**Statement of Roger Joslin**

**Chairman of the Board**

**State Farm Fire and Casualty Company**

**On**

**The Homeowners' Insurance Availability Act of 1999, H.R. 21**

**Before the House Banking and Financial Services Committee**

**July 30, 1999**

### INTRODUCTION AND SUMMARY

My name is Roger Joslin. I am Chairman of the Board, State Farm Fire and Casualty Company, the largest writer of homeowners insurance in the United States.

State Farm strongly supports a federal role in providing a financial backstop in the event of very large natural catastrophes. H.R. 21, the Homeowners' Insurance Availability Act of 1999, represents a very sound approach to the natural disaster issue. It reflects many improvements over earlier versions and includes helpful recommendations from the Treasury Department. We complement the Committee Chairman, the Ranking member, Mr. LaFalce, Housing Subcommittee Chairman Lazio, Representative McCollum, Representative Bentsen and other committee members from both sides of the aisle for their continuing efforts on this important issue.

There are several principles that should be followed in developing legislation in this area. First, the resources of the federal government should be called upon only rarely; for example, only for events approaching the magnitude of Hurricane Andrew and the Northridge California earthquake, or events likely to occur less frequently than once per 100 or more years. Second, the price of federal backstop mechanisms should properly reflect expected losses--no subsidies for catastrophe prone areas--while recognizing the superior capacity of the federal government to absorb the timing risk of mega catastrophes. Third, the backstop mechanism should have continuity so as not to evaporate during or following a major event. Fear of a second event may be even more disruptive of market mechanisms than concern about the consequence of a first event. H.R. 21 meets the first two principles head on. It also recognizes the third principle's importance, but can be strengthened in this regard.

A 100, 500, 1,000, 10,000 year event by definition occurs very rarely. Yet such an event could happen tomorrow. All those with a stake in this issue -- the insurance buying public, the states, the private sector and the federal government -- must play a role in crafting a solution. Now, when the country is free from the trauma associated with a major catastrophic event, is the time for Congress to enact legislation creating a meaningful Federal-state-private partnership to lessen the impact of disasters.

### THE PROBLEM

According to well accepted estimates, insured losses from major natural catastrophes in several regions of the country such as California, the Southeast including but not limited to Florida, and the Midwestern earthquake zone, could reach as high as \$75 billion to \$100 billion. Events of this magnitude far exceed the claims paying capacity of most private insurers and all existing state funds. Other regions facing potentially devastating catastrophic losses include the upper Atlantic Coast, ranging from New Jersey north, the Gulf States, ranging from Texas east, and the Pacific Northwest. Smaller markets with very high potential losses relative to their size include Hawaii and Alaska.

A large segment of the U.S. population resides in disaster prone areas and due to considerations such as climate and job growth that proportion is growing. Florida provides an excellent example of this trend. According to Florida's Department of Community Affairs, during the last active hurricane period (1930 to 1950) the population ranged from 1.47 million to 2.77 million. Today, Florida has nearly 15 million residents of which nearly 80 percent live in a coastal county. Moreover, 6.5 million people live within five miles of the coast. California, Texas, Long Island, New Jersey and the Southeast have experienced similar trends. These trends and the relatively high value of real estate in these areas create the potential for mind boggling catastrophic losses.

While we can point to the New Madrid earthquake of the early 1800s, the 1906 San Francisco earthquake, the 1938 Long Island hurricane, Andrew and Iniki in 1992, and Northridge in 1994, as examples of major catastrophes, none of these represent the worst that can happen. Further, the relatively small number in our consciousness brings home the fact that the largest of natural catastrophes are very infrequent occurrences.

Yet after Iniki, Andrew and Northridge, the homeowners insurance markets in Hawaii and major parts of Florida and California became dysfunctional. State-sponsored mechanisms to assume and pool the most severe risks were the responses necessary to reopen insurance, and thus real estate, markets.

These necessary, but limited, mechanisms would barely be able to respond to events the size of Andrew and Northridge, let alone the very possible much larger catastrophes. They would for many years have absolutely no ability to cope with a second event. The California Earthquake Authority currently has the capacity to pay up to approximately \$7.25 billion in earthquake losses. The Florida Hurricane Catastrophe Fund currently provides approximately \$11 billion of reinsurance coverage to primary insurers. All but \$2 to 3 billion of this is supported by authority to impose post event assessments to repay loans, not genuine prepaid risk transfer. The Hawaii Hurricane Relief Fund would not be able to pay all the claims from another Iniki (which hit the small island of Kauai) let alone a severe storm hitting Honolulu on Oahu.

#### Capacity/Price

Theoretically, there is more than enough capacity (capital) in private markets to insure/reinsure the worst of natural disasters. Reality, for a number of reasons, is otherwise.

Primary insurers in the aggregate have substantial capital, but relatively little of it is devoted to homeowners insurance in mega catastrophe prone areas. Many companies do not insure homes. Many which do, do not write in the "break the bank" areas. One factor discouraging companies from writing in these areas is politically motivated rate suppression. Those who do write homeowners insurance in these areas restrict their exposure due to limited capital or concern about earnings volatility.

The entire capital base of reinsurers is not large and they must balance their portfolios. Only a fraction of their capital is available to assume risks in any single area.

The capital markets--pension funds and other institutional investors--have large financial resources, but very little of it has reached the catastrophe insurance market. And the price has been high--8.2 times the estimated annual average loss cost in the largest transaction to date. Other transactions have been priced at levels of three to seven times the estimated annual coverage loss costs. After a major event, the price of such securities, if available at all, most likely would be higher.

In response to a specific question posed by the committee, one or two years of profitability, or three years without an event of the magnitude of the Northridge earthquake, changes nothing in regard to the need for federal financial backup for events having an occurrence likelihood of less than once in 100 years. I am reminded of commentary in Florida to the effect that, except for a single isolated event, the insurance business in Florida has been profitable. That single isolated event consumed more capital in half an hour than State Farm Fire and Casualty had accumulated countrywide in its 60 years of existence.

### Risk of Ruin

Actuaries have formulas placing prices on exposing pools of capital to the risk of ruin (bankruptcy). As one could expect, the owners of capital expect a higher return when there is a risk of total loss.

Too often financing of a natural catastrophic loss is described as accumulating the funds necessary to pay the loss over a period of years. Unfortunately, a 100-year event can occur in the first year. Even more frightening, so can a 10,000 year event. No private enterprise can earn a competitive rate of return in the business of insurance sitting on this quantity of stagnant capital.

United States tax policy further aggravates the problem. In most years, insurance of high magnitude, low incidence events generates tax liabilities on profits that really do not exist. Yet in 1997 the loss carry-back period was reduced from three to two years. Even if the proverbial 100 year event were to occur at the statistical mid-point of 50 years, 49 years of profits would have been taxed with only two of those years being available for recovery.

### THE SOLUTION

As Jack Nicholson, director of Florida's Hurricane Catastrophe Fund, testified before the Housing Subcommittee, "A federal backstop is needed for pre-event funding for a future catastrophe. States can only do so much on their own. It is much wiser to have an established relationship among the private insurance market, state programs, and the federal government before a catastrophe..." H.R. 21, the Homeowner's Insurance Availability Act of 1999, creates the needed partnership. Its most important features are: 1) federal reinsurance for the state

funds set up to insure or reinsure catastrophic risk; and 2) a price based on estimated average annual losses plus a reasonable margin for the contingency of loss estimation error.

In regard to the federal financial backup of private insurers, State Farm does not support the Federal government providing individually negotiated reinsurance on a company specific basis. H.R. 21 avoids this quagmire. State Farm does support the concept of an auction of excess of loss contracts to private insurers, reinsurers and even the capital markets on a state, regional or national basis. Because market imperfections and failures have largely been in the area of residential insurance, if choices must be made, backup priority should be for residential insurance. However, the very largest estimates of potential catastrophic losses clearly include insured commercial property losses. Even though State Farm has a relatively small non-residential property insurance portfolio, we urge consideration of extension of the excess of loss contract concept to include non-residential property insurance coverages.

As the Treasury Department has suggested, one aspect of H.R. 21 which could be strengthened is the commitment to fully fund the large losses, which fall within the scope of the federal backup promise. The potential for a second event seriously disrupts markets. Florida has recognized the importance of funding the second event by its enactment of "Second Season" legislation to partially recapitalize its Hurricane Catastrophe Fund. If a major storm depleted the fund, there would be a partial recapitalization, but it would not occur until the next hurricane season. Moreover, only \$5.3 billion in capacity would go into the fund, which is clearly inadequate to address a major storm. Again, no single state, even if it has significant private sector support, is equipped to handle a series of major events. This includes multiple mega events in the same year. The mere possibility of unfunded catastrophic losses sends tremors through the insurance and lending communities. Last year, the committee took a step in the right direction by including language permitting the Treasury Department to offer reinsurance purchasers the option of buying similar coverage upon the exhaustion of the purchaser's original contract. Along these lines, the Committee should also consider transforming the bill's \$25 billion limit on the federal backstop from a per year to a per event limitation.

In conclusion, I want to thank the Chairman for holding this important hearing and giving me the opportunity to appear before the Committee. There is an urgent need for federal legislation to address the natural catastrophe issue. Major weather and seismic events are increasingly likely and the number of citizens exposed to these hazards is escalating. The federal government has a critical role to play in this process in partnership with the insurance buying public, the states, and the private sector. It should enact meaningful legislation, such as H.R. 21, to create a meaningful federal-state-private partnership to lessen the impact of these disasters.

I would be happy to respond to questions from members of the Committee.

---

**TESTIMONY  
of  
Randal Hanna  
Deputy Commissioner  
Mississippi Insurance Department**

before the

**House Banking Committee on Banking and Financial Services**

**July 30, 1999**

regarding

**H.R. 21**

**The Homeowners Insurance Availability Act of 1999**

Good Morning. My name is Randal Hanna and I am Deputy Insurance Commissioner for the State of Mississippi. I appreciate the opportunity to provide the Committee comments on H.R. 21, "The Homeowners Insurance Availability Act".

As you know, Mississippi borders the Gulf of Mexico and has had a long history with hurricanes, including Hurricane Camille which killed 144 residents and caused \$1.3 billion in property damage in 1969. A list of the ten hurricanes damaging our state and dating back to 1893 is attached for your information.

Along our three coastal counties, property owners have a limited selection of companies from which to purchase coverage for their homes. Three companies write over 50 percent of the business in this area- State Farm; Allstate and Mississippi Farm Bureau. Their presence is vital to maintaining market stability.

The Gulf Coast is a very volatile insurance market. Many companies are continually changing their underwriting strategies. This cycle creates a disruptive market and reflects the underlying issue of property companies unable to commit to a consistent pattern of controlled growth. The Mississippi Windstorm Underwriting Association, a market of last resort for residents unable to obtain traditional insurance coverage, has more than doubled in size since 1993. This is as a result of tremendous growth in the area and the limitations on access to commercial insurers.

One of the most important factors in determining the availability and affordability of homeowners insurance is the ability of the primary carrier to obtain reinsurance. Because state regulators do not approve reinsurance rates and most reinsurers are located outside the United States, I cannot provide you with first hand reports about reinsurance markets or reinsurance capacity.

From the insurance executives I speak with, they report the current market for reinsurance is "hot." Mississippi Farm Bureau Mutual Insurance Company is the largest property insurance company domiciled in our state. Company officials report they can buy more reinsurance than they did several years ago and at a lower overall cost. They have determined this is due to the decrease in the number and severity of catastrophes around the world in the last several years.

However, this has not always been the case. Several years ago, when a series of natural disasters occurred both here and abroad, there was great concern about shrinking reinsurance markets and the escalating prices primary insurance companies had to pay for reinsurance coverage. There is

is question that a series of future catastrophes could once again affect the availability and affordability of insurance.

The Mississippi Insurance Department supports the effort of Congress to enact a federal reinsurance program. This plan should reduce the erratic pricing and availability of reinsurance, which will likely result in a more stable primary homeowners insurance market. As regulators, a stable market should be one of our most important priorities. Where there may be some technical issues with H. R. 21 that need to be resolved, the basis for the legislation is sound and we encourage the Committee to move forward with enactment.

We cannot afford another series of insurer insolvencies similar to those which occurred in Florida after Hurricane Andrew. The Florida Insurance Department reported to you in recent testimony that they placed 11 insurers in rehabilitation and/or liquidation as a result of that storm.

It is hard to imagine the number of insolvencies we will experience if there is a 100-year storm which hits a more densely populated area of the United States. Certainly, such an event would do great damage to the market throughout the country. H.R. 21 can help to address this critical issue.

Hurricanes in most cases are multi-state events. This means that it is likely that insurance markets in several states can be affected by a single storm. Even when the damage is confined to



a single state, the effect on the insurance market can be regional, as was the case with Andrew. It makes sense that there is a federal program to deal with the problem comprehensively, rather than leaving each state to handle the crisis alone.

As the committee deliberates H.R. 21, I would ask you to consider a particular issue concerning the sale of reinsurance contracts sold through federal auction. Under the current language, contracts are sold on a regional basis. Companies which only write in Mississippi, for example, would be required to purchase contracts covering losses that might occur in neighboring Alabama or Louisiana, even though they write no business in these areas. A fairer option would be to allow these companies to purchase coverage priced solely on the basis of their single-state exposure. This approach would be fairer to all parties, but particularly to smaller domestic insurers which might otherwise not have sufficient incentive to participate in the program. It is also important that the triggers in the bill be kept at a reasonable level for the same purpose.

In closing, I would like to commend the Committee for addressing this matter, which is of real concern to residents of the Mississippi Gulf Coast. We look forward to working with the Committee and providing whatever technical assistance you may require for the success of this program.

## HISTORY OF HURRICANES AFFECTING THE STATE OF MISSISSIPPI:

\*The first recorded hurricane that hit the Mississippi Gulf Coast was October 1, 1893 killing more people and causing more damage than any previous storm. The storm wrecked the seafood industry and knocks out Biloxi, Mississippi's one week old electric light system.

\*November 19, 1906 a hurricane kills 350 people in Mississippi and Louisiana.

\*September 29, 1915, another hurricane left 500 dead in Mississippi and Louisiana.

\*September 19, 1947, a hurricane kills 27 people in Mississippi and causes great damages.

\*June 25-30, 1957 Hurricane Audrey kills 390 people in Mississippi, Alabama, Louisiana and Texas.

\*October 4-7, 1964, Hurricane Hilda kills 38 persons in Mississippi, Georgia and Louisiana.

\*September 7-12, 1965, Hurricane Betsy kills 74 people in Mississippi, Florida and Louisiana.

\*Hurricane Camille hits the Mississippi Gulf Coast August 17 & 18, 1969 killing 144 residents and resulting in \$1.3 billion in property damage in Mississippi alone.

\*Hurricane Frederic strikes September 12, 1979, resulting in millions of dollars damages in Mississippi alone with more than 400,000 evacuated from coastal areas in Mississippi, Alabama, Florida and Louisiana.

\*On September 2, 1985, Hurricane Elena leaves one death and \$10 million in damages.

\*September 21, 1998, Hurricane Georges strikes the Mississippi and Alabama Gulf Coast.

**RAA**  
**REINSURANCE**  
**ASSOCIATION**  
**OF AMERICA**

STATEMENT

**STATEMENT**

**Hearing on**  
**H.R. 21, the Homeowners Insurance**  
**Availability Act of 1999**

**before the**  
**House Banking and Financial Services**  
**Committee**

**Franklin W. Nutter**  
**President**  
**Reinsurance Association of America**

**July 30, 1999**

1301 Pennsylvania Ave., N.W.  
Suite 900  
Washington, D.C. 20004-1701  
202/638-3690

## EXECUTIVE SUMMARY - REINSURANCE ASSOCIATION OF AMERICA

The Reinsurance Association of America (RAA) believes that H.R. 21 is a sound foundation for addressing a federal role in financing natural catastrophe losses. The creation of a federal reinsurance program is of great importance to our member companies. We firmly believe that federal involvement is a necessary component of any ultimate solution.

However, the RAA would like the Committee to readdress the level at which the federal Treasury assumes the cost and risk of a natural disaster. We urge the Committee to fully consider the capacity of both the primary and reinsurance marketplace to bear catastrophic risk. We propose that higher attachment levels ("triggers") for the government's role be incorporated to better reflect the private sector's risk bearing capacity. The RAA believes that such a change will help ensure that the private marketplace is not unnecessarily infringed upon and that the federal Treasury is not at risk by assuming too much of the cost of financing these disasters.

### **CAPACITY IS ABUNDANT IN THE REINSURANCE MARKETPLACE:**

- ❑ There is currently an overabundance of reinsurance capacity in the U.S. Reinsurance broker, U.S. Re Corporation, has just released a new report reflecting the current marketplace for reinsurance. The July 28 1999, U.S. Re report states that: (1) there is approximately \$13-\$15 billion of "excess of loss" catastrophe reinsurance capacity in place per region, per event in the U.S.; (2) an additional 40 percent of capacity is in place from other forms of reinsurance being purchased (facultative, per risk of loss and proportional); and (3) that an additional \$1 billion of capacity per region is also available from capital markets products. These factors would result in approximately \$20 billion of catastrophe reinsurance capacity available per region, per event. This number does not include the capacity provided by the primary industry to finance catastrophes. A Renaissance Re report reaches a very similar conclusion about the capacity of the reinsurance marketplace.
- ❑ Two state panels have determined that there is overcapacity in the reinsurance marketplace. In February of 1999, the Louisiana Property Insurance Task Force reported to the State Legislature that there is **overcapacity in the reinsurance market**, without even counting capital markets capacity. The report concluded that in Louisiana alone, it is estimated that it would take a market loss of over \$13 billion to exceed the catastrophe reinsurance limits purchased. In February of 1999, a New York Panel on Homeowners' Insurance Coverage reported to Governor Pataki and the State Legislature that **there is a current overabundance of reinsurance capacity in the marketplace** and that "losses from a 250-year storm striking New York would be in a range of \$6 billion. This amount is easily within the industry's current capacity to absorb."
- ❑ Guy Carpenter Inc., a reinsurance broker, reported in November of 1998 that the **capacity of reinsurance has risen** and insurance companies can now purchase traditional catastrophe excess coverage above \$500 million per event, per insurer, as compared to \$200 million in 1992.

**COST OF REINSURANCE:** It has been suggested that reinsurance prices are too high and that is why insurance companies are unwilling to expand coverage in risk-prone areas. The cost of catastrophe reinsurance is very low and has in fact dropped for five years in a row.

- ❑ On June 1, 1999, Paragon Risk Management Services issued its Catastrophe Price Index

(measure of domestic reinsurance catastrophe prices) and reported that reinsurance prices for renewals for January 1, 1999, have dropped for the ninth semi-annual period in a row. Paragon's report concludes that **global catastrophe pricing remains under pressure as reinsurance capacity exceeds demands in all regions.**

**PRIMARY INSURANCE MARKETPLACE:** The primary industry is also well-prepared to handle the cost of a natural disaster. The Committee must consider the capacity of the primary insurers (not just reinsurers) for they are responsible for absorbing some of the cost of a natural disaster. Historically, the primary insurers have paid 2/3 to 3/4 of catastrophic claims, passing the remainder through to reinsurers. Here are some facts about the primary marketplace:

- According to a July 14, 1999, Wharton School Catastrophe Risk Management Study analyzing the capacity of the U.S. property insurance industry's ability to finance major catastrophic losses, the insurance industry **has more than adequate capacity to pay at least 98.6 percent of a \$20 billion loss.** For a catastrophe of \$100 billion, the industry could pay at least 92.8 percent. **The report concludes that the gaps in catastrophic risk financing are presently not sufficient to justify Federal government intervention in private insurance markets in the form of catastrophe reinsurance.**
- According to A.M. Best, insurance industry surplus currently stands at \$332.3 billion, an increase from 77.1 percent since 1994 after the insurance industry suffered losses from Hurricane Andrew and the Northridge Earthquake. Policyholder surplus for the top five homeowners insurers, controlling 49 percent of the market share (State Farm, Allstate, Farmers, Nationwide and Travelers) currently stands at \$87.4 billion, more than doubling their surplus over the last five years.

**CAPITAL MARKETS:** Capital markets have developed and implemented products to securitize insured catastrophe risk and provide additional capacity to insurers (\$2.5 billion in 1998). The potential capacity should not be ignored or underestimated during the Committee's consideration of H.R. 21.

**STATE SOLUTIONS TO THE CATASTROPHE EXPOSURE:** The RAA believes that the state insurance departments play an important role in the issue of homeowners availability in disaster-prone areas. State insurance departments have been working with insurers to allow changes in policy coverages and premiums that bring premiums in line with the risk of catastrophes in their markets and give consumers options in line with their resources.

**MITIGATION:** The RAA believes that both the federal government and the state insurance department should encourage mitigation in disaster prone areas. Such mitigation will assist in mitigating the effects of a mega-catastrophe.

**Notwithstanding these positive developments, a fundamental problem facing insurers and their policyholders remains: the threat of a mega-catastrophe that exceeds the resources of the insurance and reinsurance markets. The RAA believes that federal involvement is a critical component of any solution to this very important issue. The RAA urges the Committee to thoroughly evaluate the capacity of the primary, reinsurance marketplace and capital markets. We believe doing so will result in your support for higher trigger levels which will minimize the risk assumed by the federal Treasury and maximize the resources of the private insurance industry.**

The RAA looks forward to working with the Committee as it considers H.R. 21.

**STATEMENT**

**on**

**H.R. 21, the Homeowners Insurance Availability Act of 1999**

**before the**

**House Banking and Financial Services Committee**

**presented by**

**Franklin W. Nutter**

**President, Reinsurance Association of America**

**July 30, 1999**

Chairman Leach and Members of the Banking Committee, it is an honor to appear before you on behalf of the Reinsurance Association of America. We commend you, Mr. Leach as well as Messrs. McCollom and Lazio, in particular, for your leadership in promoting legislation to address the issue of natural catastrophe exposure and insurance.

The Reinsurance Association of America (RAA) represents U.S. domestic property casualty reinsurers.<sup>1</sup> The creation of a federal reinsurance program is of great importance to our member companies. Over the years, the RAA has supported efforts to create a federal role to address the issue of natural disaster catastrophe exposure in the United States. Our members firmly believe that federal involvement is a necessary component of any ultimate solution to this very important issue.

H.R. 21 is a sound foundation for addressing a federal role in financing natural catastrophe losses. However, the RAA would like the Committee to readdress the level at which the federal Treasury assumes the cost and risk of a natural disaster. We urge the Committee to fully consider the capacity of both the primary and reinsurance marketplace to bear catastrophic risk. We propose that higher attachment levels ("triggers") for the government role be incorporated to better reflect the private sector's risk bearing capacity. The RAA believes that such a change will help ensure that the private marketplace is not unnecessarily infringed upon and that the federal Treasury is not at risk by assuming too much of the cost of financing these disasters.

#### **RAA PRINCIPLES OF NATURAL DISASTER POLICY**

The reinsurance industry has maintained a consistent position on the need for a federal backstop when the costs of a natural disaster exceed the private market capacity. Such a federal role is crucial to protect the solvency of the insurance marketplace and maintain insurance markets for consumers.

---

<sup>1</sup> Often described as "insurance for insurance companies," reinsurance is a sophisticated transaction by which one insurer indemnifies, for a premium, another insurer against all or part of a loss that it may sustain. The fundamental objective of insurance, to spread risk of loss, is thereby enhanced by the insurer's ability to spread that risk through reinsurance.

The key reasons a primary company purchases reinsurance are: (1) to limit liability on specific risk; (2) to stabilize loss experience; (3) to protect against large losses; and (4) to increase capacity so they can write more policies. The degree to which each insurer will utilize reinsurance for one or all of these purposes is determined by each insurer after assessing its own exposure to losses and its own capital resources.

Providing catastrophe insurance and reinsurance coverage should otherwise be preserved for private sector carriers. State government catastrophe funds<sup>2</sup> should only be employed as a last resort.

That position is rooted in the following principles, which we urge the Committee to adopt as its own:

- (1) natural catastrophe exposures, hurricanes and earthquakes, are insurable risks in the private sector;
- (2) government's role should only be to address insurer solvency in the event of a mega-catastrophe, hereby fostering private sector coverage and preserving the claims paying ability of insurers;
- (3) the risk of natural catastrophes is best insured in a diversified marketplace which avoids concentration of risk in too few insurers or state programs;
- (4) the private sector's role, including insurance, reinsurance and capital markets, should be maximized and such financing mechanisms fully exhausted before any government capacity is provided, state or federal;
- (5) the government should encourage, and – where appropriate – fund pre-disaster hazard mitigation efforts; and
- (6) any federal proposal should not put taxpayers' dollars at risk when the private sector is more than capable of financing the costs of a natural disaster.

These principles form the basis for the RAA's evaluation of all disaster-related legislation, whether they be federal or state proposals. They are founded solely in the belief that the private sector is the appropriate bearer of catastrophic risk, but are tempered by the recognition that a natural event could occur, one greater than any which has occurred to date, which exceeds the resources of the U.S. insurance and global reinsurance industries.

---

<sup>2</sup> A state run tax-exempt trust fund that provides reinsurance to insurance companies writing homeowners insurance in a particular state.



## CAPACITY TO FINANCE NATURAL DISASTERS

At the heart of the debate on H.R. 21 is what is the capacity of the insurance industry to finance natural disasters. It is critical in evaluating capacity of the industry that the Committee keep in mind that insurance capacity for natural disaster exposures is provided by insurers, reinsurers and the capital markets. The bulk of catastrophic risk is retained by primary insurers which provide coverage directly to the public. Such coverage represents the typical homeowners contract where an insurance company agrees to indemnify their customer, upon receipt of a premium, for a loss or damage to property. The primary insurance industry is in the business to pay claims and finance losses associated with a natural disaster. Reinsurers provide protection for insurers in the face of large catastrophe losses but our segment of the industry, by premium volume or surplus, is roughly one sixth the size of the primary industry.

Although reinsurers assume the risk of a significant portion of most insurance companies' catastrophe losses, several of the largest national personal lines insurers, for example, purchase very little reinsurance because their resources, as reflected in their capital and surplus, are large enough to retain risk and absorb shock losses. For instance, the six companies represented today on this committee have a combined surplus of approximately \$70 billion.<sup>2</sup>

A number of reinsurers, however, may rely more on reinsurance to spread their risk of loss. No insurer should or wants to expose its entire capital base to a threat of a single natural catastrophe or to an accumulation of catastrophes. In addition, insurers have a responsibility to stockpile reserves to the best of their own resources, public shoulders to see that their capital provides an adequate cushion or safety net in the event of a risk of loss from natural catastrophes.

Thus, in the Committee's judgment, the most important issue is not the industry's capacity to pay catastrophe claims, but the most credible capacity of the insurance industry and market to absorb major catastrophes. In addition, the Committee must not ignore the ever-growing capacity brought to the capital markets.

<sup>2</sup> American Old Republic - \$10 billion; CNA - \$7.5 billion; Farmers - \$7.5 billion; Metropolitan - \$7.5 billion; Sun Life - \$7 billion; American - \$7 billion; New York World - \$7 billion.

## REINSURANCE CAPACITY ABOUNDS AND PRICES CONTINUE TO FALL

There is currently an abundance of catastrophe reinsurance available in the marketplace today. As Standard and Poor's recently reported, there is currently an overabundance of reinsurance in the marketplace and the "glut of capacity in the reinsurance marketplace will continue to hold back rate increases. Capital is very, very, strong in the reinsurance market."

Unfortunately, during consideration of this measure last Congress, the Committee relied on a U.S. Re Corporation report as to what the reinsurance capacity is in the U.S. Again this year, the U.S. Re report is cited as evidence of the limited availability of reinsurance in any single region. That U.S. Re report concluded that there was \$7 billion of reinsurance available per region. However, several considerations apply: (1) it is a 1995 report based on an analysis of the marketplace in 1994 just after the Northridge Earthquake (1994) and Hurricane Andrew (1992) and; (2) the report only took into account one form of reinsurance, "excess of loss,"<sup>4</sup> and did not take into account the other forms of catastrophe reinsurance available for purchase (facultative, per risk excess of loss and proportional) which make up an additional 40 percent of capacity. **U.S. Re has just released a new report reflecting the current marketplace for reinsurance. (See Attachment A). We urge the Committee to rely on this report as extensively as it did in its consideration of H.R. 219 last year. The July 1999, U.S. Re Report states that:** (1) there is approximately \$13-\$15 billion of "excess of loss" catastrophe reinsurance capacity in place per region, per event in the U.S.; (2) an additional 40 percent of capacity is in place from other forms of reinsurance being purchased (facultative, per risk of loss and proportional); and (3) that an additional \$1 billion of capacity per region is also available from capital markets products. These factors would result in approximately \$20 billion of catastrophe reinsurance capacity available per region, per event. This number does not include the capacity provided by the primary industry to finance catastrophes.

The RAA believes that this more recent and thorough data presents a much more accurate picture of the reinsurance marketplace. We urge the Committee to consider the current U.S. Re report as well as the following in its consideration of the level of which the federal government should get into the business of reinsurance. We believe the abundance of reinsurance in the marketplace warrants the raising of the trigger levels in H.R. 21.

---

<sup>4</sup> Excess of loss is one form of catastrophe reinsurance. Excess of loss provides a defined limit of coverage that indemnifies the company above a specified loss amount.

- ❑ Consistent with the new U.S. Re report, a July 1999, Renaissance Re report (*see Attachment B*) analyzing the reinsurance marketplace, concludes that: (1) there is approximately \$14 billion in capacity, per event, per region of excess of loss reinsurance **purchased** by the primary marketplace at this time; (2) reinsurers are offering additional capacity in the excess of loss market, but many insurance companies have decided to retain the risk on their own balance sheet, rather than purchase reinsurance; and (3) in addition to the \$14 billion of excess of loss reinsurance available per region, there is additional reinsurance catastrophe protection currently being purchased from other forms of reinsurance agreements including, proportional, facultative and per risk excess of loss contracts. This additional protection adds approximately 40 percent more reinsurance being purchased, resulting in approximately \$20 billion of reinsurance sold per region. This number does not include the capacity of the primary industry to finance catastrophes. (Renaissance Re is one of the largest catastrophe writers in the world. It maintains an exhaustive database of all catastrophe offerings and are considered to have the most comprehensive database of catastrophe cover purchased in the U.S.)
  
- ❑ In February 1999, the Louisiana Property Insurance Task Force reported to the State Legislature that there is **over capacity in the reinsurance market**, without even counting capital markets capacity. The report concluded that in Louisiana alone, it is estimated that a market loss of over \$13 billion alone would be needed to exceed the catastrophe reinsurance limits purchased.
  
- ❑ In February 1999, the New York State Temporary Panel on Homeowners' Insurance Coverage reported to Governor Pataki and the State Legislature that **there is a current overabundance of reinsurance capacity in the marketplace** and that "losses from a 250-year storm striking New York would be in a range of \$6 billion. This amount is easily within the industry's current capacity to absorb."
  
- ❑ Guy Carpenter, a reinsurance broker, reported in November of 1998 that the reinsurance capacity has risen and insurance companies can now purchase traditional catastrophe excess coverage above \$500 million per event, per insurer, as compared to \$200 million in 1992.
  
- ❑ Evidence of this high level coverage came in January 1999 when State Farm and Renaissance Re announced the formation of Top Line Re which will provide \$3 billion in high level excess catastrophe coverage for non-U.S. business. The marketing plan, according to press reports,

envisions that Top Line Re will make \$500 million in high layer, catastrophe aggregate excess coverage available per insurer. Even though Top Line Re will not make the coverage available for U.S. insurers, its creation means competition is increasing in this sector.

It has also been suggested by witnesses before the Subcommittee on Housing and Community Opportunity that insurance agents are unable to sell homeowners insurance policies because "unnamed insurance companies" inform them that it is too expensive to buy reinsurance. The fact is, reinsurance prices are very low and have dropped for five years in a row. We urge the Committee to consider the following when addressing the catastrophe pricing issue:

- ❑ On June 1, 1999, Paragon Risk Management Services announced its Catastrophe Price Index (measure of domestic reinsurance catastrophe prices) and reported that reinsurance prices for renewals for January 1, 1999, have dropped for the ninth semi-annual period in a row. Paragon's report concludes that **global catastrophe pricing remains under pressure as reinsurance capacity exceeds demands in all regions.**
- ❑ Guy Carpenter Inc, a reinsurance broker, issued a 1998 report noting that its **reinsurance placements on behalf of clients continue to indicate a decline in the cost of reinsurance, noting that the cost of reinsurance is now close to Pre-Andrew levels.** The report also notes that the prices for catastrophe reinsurance contracts have declined for five years in a row.
- ❑ The reinsurance contract with the California Earthquake Authority (CEA) has been cited by proponents of low triggers as evidence of high reinsurance prices. What is not pointed out is that the CEA renegotiated its reinsurance contract with reinsurers in 1999 and just completed negotiations on the 2000/2001 contract. The recent CEA contracts only highlight how low reinsurance prices currently are in the marketplace. Here are a few details of the new CEA reinsurance contract confirmed by the CEA:

For 1999, the "rate on line"(term used for the price of the reinsurance premium) will decrease from the 14.375 percent in the 1997/1998 contract to 11.0 percent in the 1999 contract. How much money does the CEA save with the new rate: **a \$47 million savings, a 23.4 percent reduction.** For 2000/2001 the "rate on line" will decrease to 8.5 percent, reducing the CEA's premium cost by nearly 30 percent, thus reducing the CEA's reinsurance costs by approximately \$39 million.

The reinsurers also provided the CEA with a "no claims bonus" if 1999 or 2000 goes by claim free, just as 1997 and 1998 have. If the CEA treaty is loss free as of 12/21/99 or 12/31/00 reinsurers will return 12.5 percent of premiums collected in all three years (1997-1999). According to the then CEA Chief Executive Officer Greg Butler, "the CEA was in a good position to negotiate, given the excellent loss experience (no claims), good operating performance, and **excess capacity in the reinsurance markets**. We asked a lot from the reinsurers, and a majority of them stepped up to the plate."

There are record amounts of reinsurance capacity available today. Ironically, this is due in part to the unprecedented insurer losses associated with Hurricanes Andrew (\$15.5 billion) and Inki (\$1.6 billion) which prompted an assessment of conventional insurance and reinsurance risk. Insurers and reinsurers reviewed their insured exposures and risk management programs and decided to revise their business plans for the coming years. Since 1994, reinsurers, investment bankers, and financial market traders developed additional contingent capital, reinsurance, and derivative risk management products and added new capacity through newly capitalized companies. This has led to the over capacity in the marketplace.

It appears that the capacity will continue to grow in future years as well. In 1998 reinsurance broker Guy Carpenter made the following prognosis about the future of reinsurance during the Louisiana Coastal Task Force hearings: (1) there will be excess capacity, price reductions and continuity of market (the larger catastrophes are more easily absorbed by reinsurers without market concentration); (2) catastrophe reinsurance will continue to become more available and affordable; and (3) more sophisticated customized products will be developed and there will be lower transaction costs. The following contributing factors that cause this positive outlook on future market conditions were cited:

- Mergers and acquisitions, larger companies will assume larger amounts of risk;
- Strong investment returns;
- Entry of new players and new distribution channels including: (a) investment banks; (b) capital market investors; (c) alternative markets; and (d) strengthened Bermuda reinsurance capacity.

## PRIMARY MARKETPLACE ALSO WELL PREPARED TO FINANCE NATURAL DISASTERS

Historically primary insurers have paid 2/3 to 3/4 of catastrophe losses, passing the remainder through to the reinsurance industry. The primary industry is also well-positioned to finance natural disasters. As previously stated, it is very important for this Committee to consider the capacity of the primary insurers (not just reinsurers) in its consideration of the trigger levels in H.R. 21. Although H.R. 21 is a proposal to create a federal reinsurance program, the primary industry plays just as critical of a role in financing these natural disasters.

- According to a July 14, 1999 study by the Wharton School at the University of Pennsylvania, entitled, "Managing Catastrophe Risks" which analyzed the capacity of the U.S. property insurance industry's ability to finance major catastrophic losses, the insurance industry **has more than adequate capacity to pay at least 98.6 percent of a \$20 billion loss.** For a catastrophe of \$100 billion, the industry could pay at least 92.8 percent. **The report concludes that the gaps in catastrophic risk financing are presently not sufficient to justify Federal government intervention in private insurance markets in the form of catastrophe reinsurance.**
- According to A.M. Best, the insurance industry surplus currently stands at \$332.3 billion, an increase from 77.1 percent since 1994 after the insurance industry suffered losses from Hurricane Andrew and the Northridge Earthquake. The policyholder surplus for the top five homeowners insurers, controlling 49 percent of the market share (State Farm, Allstate, Farmers, Nationwide and Travelers) currently stands at \$87.4 billion, more than doubling their surpluses over the last five years.
- Not only have the primary market's capital and surplus rebounded, since the disastrous effects of Hurricane Andrew and the Northridge Earthquake, most, if not all, insurers have taken steps to better assess their catastrophe exposure and put in place programs that mitigate the risk of financial impairment to their companies. These steps have included the establishment of subsidiaries devoted exclusively to high-risk markets, better management of the utilization of reinsurance, use of new capital markets products and special purposes vehicles, and catastrophe modeling to better evaluate and establish premium levels commensurate with risk.

## CAPITAL MARKETS CONTINUE TO PROVIDE CAPACITY

Over the last few years, the capital markets have developed and implemented products to securitize insured catastrophe risk and provide additional capacity to insurers. (*See Attachment C*). The capital markets potential to provide capacity for natural disasters reaches into the trillions of dollars. Some of the nation's most prominent investment banking and securities organizations have actively securitized insurance catastrophe risk, including the Chicago Board of Trade, Goldman Sachs, Morgan Guaranty Trust, J.P. Morgan Securities, Credit Suisse First Boston, AON Re Services, Sedgewick Financial, and Merrill Lynch. The market for capital markets funding of catastrophe natural exposures has grown from one transaction in 1994 totaling \$85 million to eighteen transactions in 1998 totaling approximately \$2.5 billion. While it is still in its infancy, a lot of resources are being directed by capital markets intermediaries to encourage development of the market and to complete a growing number of transactions. This development could revolutionize catastrophe insurance funding and greatly expand the capacity of the U.S. insurance market to deal with the financial risks attendant to mega catastrophes. The potential capacity from the capital markets should not be ignored or underestimated during the Committee's consideration of H.R. 21. This is particularly important in light of the likely convergence of the financial services industries if financial modernization is enacted into law.

## STATE SOLUTIONS TO THE CATASTROPHE EXPOSURE

The RAA believes that the state insurance departments play an important role in the issue of homeowners availability in disaster-prone areas. State insurance departments have been working with insurers to allow changes in policy coverages and premiums that bring premiums in line with the risk of catastrophes in their markets and give consumers options in line with their resources. Together, the overcapacity of the primary and reinsurance markets have done much to address consumer level concerns about the availability and affordability of catastrophe insurance and have provided additional security to insurers against the threat of financial impairment. Evidence of this is reflected in two recent state reports. In February 1999, the New York State Panel on Homeowners's Insurance, chaired by the state superintendent of insurance, concluded that: the New York insurance market is resilient for the availability of homeowners' insurance in coastal communities, with few exceptions, has rebounded; and that the number of homeowners' insurance policies written by the New York Property Insurance Underwriting Association (a state-mandated market to ensure availability) has leveled off and the number of new policies is declining.

In Louisiana, after the Property Insurance Task Force issued its study, the Insurance Commissioner issued a letter to Congress noting that " . . . it is crucial that our homeowners are able to obtain affordable homeowners insurance to protect their property against a major catastrophe. In Louisiana, the private marketplace is doing just that, providing homeowners with affordable and adequate coverage to protect against such a catastrophe."

Recent developments in Florida also highlight the positive developments in the homeowners insurance markets. According to the state-run Joint Underwriting Association (JUA - insurer of last resort) in April of 1999 the number of policies dropped below the 200,000 mark. The policy count for the JUA peaked in the fall of 1996, when policies totaled nearly 937,000. The JUA issued a statement that "the steady decline in the JUA policyholders is a sign that Florida's property insurance market continues to grow healthier after collapsing in the wake of Hurricane Andrew in August of 1992. Insurance companies do want to write policies in Florida and believe they can. In May of 1999, three insurance companies submitted plans to the JUA that would nearly deplete the remainder of its policies. The same three companies made a proposal to slash the policy base of the Florida Windstorm Underwriting Association nearly in half. The Association insures more than 493,000 homes in 29 coastal counties. According to a May 5, 1999 Sun-Sentinel report, "reinsurance is playing a big role in breaking the logjam of policies stuck in the pools. All three companies have pacts with large reinsurance companies."

Looking at the primary, reinsurance and capital markets, as well as state initiatives, the RAA believes that the private marketplace is more than equipped to handle losses above the levels provided for in H.R. 21.

#### **MEGA-CATASTROPHE STILL THREATENS THE MARKETPLACE**

Notwithstanding these positive developments, a fundamental problem facing insurers and their policyholders remains: the threat of a mega-catastrophe that exceeds the resources of the insurance and reinsurance markets. An insured catastrophe that, for example, exceeds 20 percent of the aggregate surplus of the industry could have a significant negative impact on the solvency of some companies and their ability to provide coverage. Currently, industry surplus stands at \$332 billion. Twenty percent of industry surplus would be a \$66 billion event. As previously cited, the Wharton school concluded that for a catastrophe of \$100 billion, the industry could pay at least 92.8 percent



of the claims, however, a significant number of insolvencies would occur, disrupting the normal functioning of the insurance market, not only for property insurance but also for other coverages.

The best approach to improve insurance affordability and availability and to prepare for the losses and devastating effects of a mega-catastrophe should include:

- Consumers who live in catastrophe-prone areas should pay a premium for insurance in direct relationship to that risk. A key component to ensure availability of insurance for these consumers is the experimentation with deductible programs. Earthquake programs have long been written with a percentage deductibles of 2 percent, 5 percent, or 10 percent of policy limits. Wind policies have typically stayed with a flat deductible. Many insurers today believe that creation of new deductible programs will provide an incentive for consumers to take steps to mitigate against property loss. Many states have taken action to approve such deductible programs.
- Consumer information programs should be enhanced. A well-publicized effort to provide consumers with information on how to obtain property insurance is necessary. If a consumer chooses not to purchase affordable insurance, there is not a lot a federal reinsurance program can do for the consumer
- States and communities working with the federal government should institute pre-disaster mitigation programs, including appropriate building codes and hazard reduction measures. Hurricane Andrew has emphasized the importance of enforcement since the Dade County, Florida, experience indicates that little or no enforcement existed for compliance with building codes. The result was billions of dollars in additional damage.
- At the federal level, a federal safety net providing protection for insurers above which they cannot absorb catastrophe losses should be put in place.

With these measures, private sector competition and capacity will continue to flourish, damage to homes and lives will diminish and, in case of a mega-catastrophe, the financial infrastructure of the industry would remain intact, thereby averting wide dislocations throughout the economy. This combination of state regulatory action and federal legislation will solve this problem.

## EVALUATION OF PROPOSED FEDERAL APPROACHES

The RAA believes that H.R. 21 is a sound foundation for addressing a federal role in financing natural catastrophes. The RAA's foremost concern in the legislation are the trigger at which the federal government would provide reinsurance. In H.R. 21, the federal government would provide reinsurance to state government-sponsored catastrophe funds once losses exceed 2 billion, a 1 in 100 year event or the claims paying capacity of the state cat fund, whichever is greater. The trigger levels for the regional contracts to be auctioned by Treasury are \$2 billion or 1 in 100 year event, whichever is greater. The RAA believes that H.R. 21 would interfere with the private marketplace and encourage the creation of more state government programs. We are seeking to incorporate higher trigger levels for the federal reinsurance program to better reflect the private sector's risk bearing capacity. As evidenced in the material above, the RAA believes these changes will help ensure that the private marketplace is not unnecessarily infringed upon and that the federal Treasury is not at risk by assuming too much of the cost of financing these disasters. We believe that low trigger levels tilt the field toward government solutions while higher trigger levels promote private solutions.

The RAA urges the Committee to consider trigger levels that preserve the solvency of the insurance industry but do not interfere with the private marketplace. Last year before this Committee, we suggested an approach which is not currently in H.R. 21, which would set the trigger level based on losses to the insurance industry or insurance company surplus. Senator Stevens' bill in the 104<sup>th</sup> Congress, S. 1043, provided for the federal reinsurance program protection to trigger for insured losses which exceed 15 percent of industry surplus or losses by an insurer of 20 percent of its own surplus. If the industry was in a decline and surpluses were down, the trigger would be a lower number. If the industry continues to be robust, the triggers automatically rise. Therefore, the trigger level would adequately reflect the capacity of the insurance industry in good times and in bad.

If the industry surplus trigger is not a viable one, the RAA proposes that at a minimum, the trigger levels for in H.R. 21, for both the state programs and the auctions of be raised to: the greater of \$5 billion, 1 in 250 year event or the claims paying capacity of the state cat fund. The RAA understands the unique situation of Florida and is willing to work with the Committee on this issue, or address any other concerns particular Members may have. The RAA is also seeking to incorporate amendments that are more technical in nature that we believe will help increase the effectiveness and fiscal soundness of the new federal reinsurance program.

### Additional Concerns about Low Triggers

- The RAA believes that the lower trigger levels will encourage the creation of state catastrophe funds. More states would then be taking on more liability for catastrophe exposures, and seeking to pass the states' liability on to the federal government. Any legislation should allow the private marketplace to assume most of the liability, before a state or federal program subjects their taxpayers to the risk of these exposures.
- The RAA believes that, together with more state funds, low triggers for federal reinsurance, and the requirement that Treasury underwrite each state fund based on risk covered and the prices charged to consumers, a federal oversight mechanism would eventually have to be created. This federal regulatory entity would have to make an evaluation of underlying rates charged to consumers (required by H.R. 21 to be actuarially sound) and oversee solvency of state funds. Higher trigger levels would negate the necessity of federal insurance regulatory oversight.
- Lower trigger levels lead to higher consumer prices. The state catastrophe funds will purchase the federal reinsurance, but in order to fund the purchase of it, will have to pass the cost down to the primary companies in the case of Florida, who in turn will pass the cost onto the consumer. In Hawaii and California, the cost of federal reinsurance will have to be directly incorporated in the cost of coverage paid directly by consumers. Low triggers mean higher cost to purchasers and consumers.

### **CLOSING REMARKS**

The RAA principles on natural disaster legislation are rooted in the belief that capitalistic incentives, operating within a flexible regulatory environment, provide ample motivation for the private sector to offer homeowners insurance in disaster-prone areas. However, they also recognize that the inherent nature of the risk associated with that coverage creates a high-capacity void that only the federal government can fill.

Those principles are further strengthened by a marketplace that has improved considerably over the last few years and is continuing to improve each passing day: insurance companies have surpluses that allow them to write more coverage; reinsurance capacity is abundant; the cost of reinsurance is

at a 5-year low; and new forms of reinsurance and capital markets are enhancing the catastrophe risk management market.

Combine these dynamic developments with the guidance exhibited by Congressional leaders as yourselves, and I am optimistic that we are approaching a private/public partnership that will help ensure the availability of homeowners insurance to consumers in disaster-prone areas, while maximizing the resources of the private sector.

I urge you to thoroughly evaluate both the capacity of the primary marketplace, the reinsurance marketplace and the capital markets. I believe doing so will result in your support for higher trigger levels which will minimize the risk assumed by the federal Treasury and maximize the resources of the private insurance industry.

**Tal P. Plotkine**  
Chairman, President &  
Chief Executive Officer

**U.S. RE Corporation**  
Reinsurance Brokers & Consultants

**USRE**

**BY FAX AND EXPRESS MAIL**

**July 28, 1999**

**Mr. Franklin W. Nutter**  
President  
Reinsurance Association of America  
1301 Pennsylvania Avenue, N.W.  
Suite 900  
Washington, DC 20002-1701

**RE: Catastrophe Excess of Loss Reinsurance Availability in the U.S.A.**

**Dear Frank:**

U.S. RE Corporation is pleased that it has been cited in the July 23<sup>rd</sup>, 1999 memorandum from the Majority Staff to the Legislative Assistants' Committee on Banking and Financial Services. This memorandum discusses catastrophe exposures and we presume data contained therein will be discussed at the hearing of July 30<sup>th</sup>, 1999 on HR.21, The Homeowners Insurance Availability Act of 1999.

In the fourth paragraph of the Memorandum, it mentions that U.S. RE has publicly stated that the total supply of available reinsurance in any single region of the United States is approximately \$7 billion. We wish to point out that this information is now substantially outdated, as it was based on an analysis our company performed in 1995/96. Since then, the capacity for catastrophe reinsurance protection has grown dramatically. In fact, based upon an analysis we have just completed, we estimate that the catastrophe reinsurance capacity for four of the key regions of the U.S.A. has now more than doubled, as follows:

North East	\$13.0 - 14.0 Billion
Carolinas	\$12.5 - 13.5 Billion
South East	\$13.0 - 14.0 Billion
Gulf & Texas	\$14.5 - 15.0 Billion

We enclose copies of our exhibit which reflects this revised analysis for your convenience. We would also like to point out that based upon our estimate, the aforementioned amounts can be increased by as

55 Park Avenue  
New York, New York 10016  
212-626-6200 Fax: 212-626-6206  
Telex: 179637 US RE CORP

much as 40% when factoring the availability of the additional reinsurance capacity coming from proportional property treaty reinsurance, per risk excess of loss reinsurance and facultative reinsurance. Moreover, additional capacity is now available from the capital markets which began to emerge in 1994. This capacity has grown since 1994/95 to approximately \$1 billion in any one zone. Consequently, the aggregate capacity is estimated to be more than \$20 billion of limit for any one zone. We also further believe that catastrophe capacity from the capital markets will grow more significantly now that investors in the security sector have begun to actively support securitization products tied to the assetization of catastrophic risk.

Considering that insurers themselves are generally prepared to retain a certain level of losses after deducting recoveries from reinsurance and other risk transfer devices, we believe that any legislation calling for a federal reinsurance mechanism should be formulated such that the federal program should not operate or trigger below an industry loss of between \$25 to \$30 billion. Furthermore, we believe that the trigger level established should be adjustable to meet future changes in capacity available from private sector mechanisms. With the foregoing in mind, U.S. RE Corporation urges the Committee and members of Congress to assure that HR21 or any similar type of proposed legislation will not be formulated in such a way as to compete with private sector reinsurance capacity.

We understand that the RAA's position is consistent with our philosophy and are prepared to assist it and the House Committee with any clarification or further information and remain at your disposal.

Sincerely,



TPP:als  
Enc  
24-84

**Attachment B**

Renaissance Reinsurance Ltd.  
 Renaissance House, East Broadway  
 P.O. Box HM 2527  
 Hamilton HMGX, Bermuda  
 Phone: (441)-295-4513  
 Fax: (441)-292-9453

**DATE:** June 11, 1999      **TIME:** 4:31 PM  
**TO:** Frank Nutter      **COMPANY:** RAA  
**FROM:** Bill Riker, President & COO  
**Re:** Reinsurance Catastrophe Capacity

Dear Frank,

Thank you for inquiring about our views on the available catastrophe capacity by region in the United States. As you know, Renaissance Re is one of the largest catastrophe writers in the world. As part of this activity we maintain an exhaustive database of all catastrophe offerings we consider and pride our selves in having the most comprehensive database of catastrophe cover actually purchased in the U.S.

We run a variety of probabilistic models against this database of catastrophe contracts to determine and understand the dynamics of the risk in the market. Up until now we have maintained this information as proprietary to ourselves, but at your request, we are willing to release a certain amount of the information we have assembled. If must be understood that the information is our best attempt to model the reinsurance business and is subject to some degree of interpretation.

Attached is an exhibit, which outlines the capacity available by major risk territory in the US. To clarify, this is the actual amount we calculate would be paid by the reinsurance market in very large events.

Total Maximum recoverable in an Event (millions)

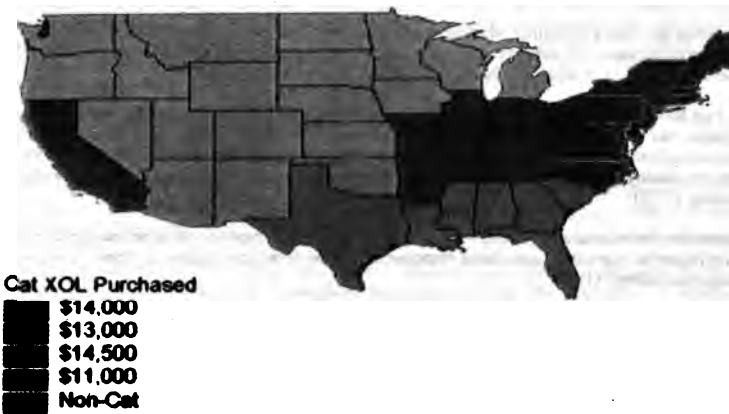
Region	Cat XOL Purchased
Northeast	14,000
Southeast	13,000
California	11,000
New Madrid	14,500

\* CAT XOL - Natural catastrophe Excess of loss reinsurance provides a defined limit of coverage that indemnifies the company above a specified loss amount.

As you can see, our data indicates there is about \$14 billion in capacity per event by region currently purchased be the primary insurance market at this time. We also believe

re is additional capacity available in the market, but companies have decided to purchase their own excess sheets. There is additional reinsurance protection that will be available through proportional, facultative and per risk excess or loss reinsurance. More research needs to be done to ascertain the amount of additional reinsurance protection in these products, but we believe these products add about 10% more potential capacity.

## Total Maximum Recoverable



Thank you for your inquiry and hope you find this information helpful.

Best regards,

Liam J. Riker



### SECURITIZING NATURAL DISASTER RISK

**Nationwide** - Nationwide has the option to issue up to \$400 million of 9.222% surplus notes to fund new business opportunities or as reimbursement to catastrophic losses. Contract with Morgan Guaranty Trust Company. (1995)

**Arkwright** - Arkwright has set up a trust to issue \$100 million in trust notes to private investors. New proceeds of the notes will be used to buy government securities held by the trust. (1996)

**AIG Combined Risks/Benfield** - Placed 5 catastrophe-linked bonds with an investment fund managed by Mercury Asset Management. Bonds will pay out if a catastrophe exceeding an agreed trigger occurs in: U.S., Japan, Australia, Caribbean, Europe or Japan. (1996)

**Hannover Re** - Sold \$100 million worth of catastrophe cover. The portfolio-linked swap is comprised of the following: Japanese earthquakes, U.S. natural catastrophes, Canadian natural catastrophes, North European storms, North European other catastrophes, Australia - all catastrophes and aviation excess of loss. (1996)

**St. Paul Re** - \$68.5 million deal through Goldman Sachs & Co. to increase capacity. St. Paul Re will cede reinsurance business from five classes under a 10 year reinsurance treaty. Investors participate in excess-of-loss underwriting by investing in bonds or preference shares. Enables St. Paul to increase capacity in 5 excess-of-loss classes: U.S./Caribbean property-casualty, European property-casualty, other property-casualty, retrocessional/Lloyd's short-tail and marine and aviation. (1997)

**Winterthur Swiss Insurance Group** - Placed \$282 million of catastrophe bonds in private capital market. The bonds cover Winterthur exposure to auto claims stemming from domestic summer hailstorms. Transaction managed by Credit-Suisse First Boston. (1997)

**Swiss Re** - Placed \$137 million in two-year bonds tied to reinsurance losses from a potential California earthquake. Swiss Re and Credit Suisse First Boston were the placement agents for the notes. (1997)

**Horace Mann Educators Corporation**: Agreement allows Horace Mann to receive up to \$100 million from Centre Re, the transactions underwriter, in exchange for an equivalent value of its convertible preferred shares in the event of a mega-catastrophe. (1997)

**RLI Corporation** - Aon Re Services developed a \$50 million catastrophe equity put (CatEPut) for the RLI Corporation. The deal was underwritten by Centre Re. In the event of a catastrophe which exhausts RLI's traditional reinsurance coverage, the CatEPut program allows RLI to sell up to \$50 million in preferred shares to Centre Re. (1997)

**USAA** - Placed \$477 million of hurricane bonds in the private placement market. The bonds will provide USAA with an excess-of-loss cover tied to a single hurricane producing losses of more than \$1 billion during a one-year reinsurance period. The syndicate managers were Merrill Lynch & Co., Goldman Sachs & Co. and Lehman Bros. (1997)

**LaSalle Re** - Aon Re, Inc. and Aon Securities Corporation developed a \$100 million multi-year Catastrophe Equity Put (CatEPut) option program for LaSalle Re. The option program allows LaSalle to issue up to \$100 million in convertible preferred shares in the event of a major catastrophe or series of large catastrophes that result in substantial losses to LaSalle Re. (1997)

**Reliance National Insurance Company** - Completed a \$40 million securitization of non-catastrophe coverage for its property, aviation, marine drilling and satellite launch exposure. The placement ties bond payment trigger points to a catastrophe index established by Swiss Re. Sedwick Lane Financial structured the deal. (1997)

**Tokio Marine & Fire Insurance Co., Ltd** - Tokio Marine has acquired earthquake risk coverage of \$90 million purchased from capital markets investors through Parametric Re, Ltd. Parametric Re issued 10-year fixed income securities with principal reduction contingent on the occurrence and severity of earthquakes within an area centered on Tokyo. Goldman, Sachs & Co. and Swiss Re Capital Markets Corporation were co-leaders for the transaction. (1997)

**Centre Solutions** - Issued \$83.5 million in catastrophe bonds. The bonds provide retrocessional catastrophe cover for natural and man-made perils which Centre Solutions has underwritten. The bonds have an expected maturity date of December 31, 1998. The bonds were placed by Goldman Sachs. (1998)

**Mitsui Marine and Fire** - Obtained \$30 million in reinsurance cover backed by event-linked swap transactions. Payment is determined by the magnitude of earthquakes in and around the Tokyo area. The cover for risks is available for a three-year period which began April 1, 1998. Swiss Re Capital Markets served as the agent for the swap transaction. (1998)

**Reliance National Insurance Company** - Purchased an option to issue multi-peril-linked insurance notes, providing a guaranteed reinsurance cost. The deal gives Reliance the right to issue notes over a three-year period to fund reinsurance coverage provided through SLF Reinsurance LTD. The notes are tied to five classes of risk: U.S. property, property outside of the U.S., aviation, marine drilling rigs and satellite launch failure. Sedwick Lane Financial structured the deal. (1998)

**USAA** - Placed \$450 million of hurricane bonds in the private market. The syndicate managers were Merrill Lynch & Co., Goldman Sachs & Co., and Lehman Bros. (1998)

**Yasuda Fire & Marine, Aon Capital Markets and Munich Reinsurance Company** - Private placement of \$80 million of catastrophe reinsurance notes that provide protection against Japanese typhoon-related losses. The notes may be triggered by either one large typhoon or two, smaller separate typhoons. (1998)

**F & G Re** - F & G Re, in conjunction with Goldman Sachs and E.W. Blanche Capital Markets, completed a \$54 million bond issuance that backs its property catastrophe excess-of-loss reinsurance contracts. The funding benefits Mosaic Re, an offshore firm that provides reinsurance on F & G Re's products. This is the first Cat bond deal to securitize multiple underlying reinsurance contracts sold to a variety of insurers. (1998)

**CNA** - Issued \$200 million of 6.6 percent notes due December 2008. Goldman Sachs is the lead manager, and Lehman Brothers the co-manager for the issue. The net proceeds will be used for general corporate purposes. (1998)

**Centre Re Solutions (Bermuda) Limited** - Sponsors its second securitization of reinsurance coverage by purchasing retrocessional capacity against Florida hurricanes from capital market investors through special purpose vehicle. Trinity Re 1999, Ltd. has used \$56.615 mm of fixed income securities due 12/31/99. The loss of principal on the bond is triggered when Centre Re Solutions (Bermuda) Ltd. incurs losses as the direct result of a hurricane under an excess of loss reinsurance policy the company has written for a Florida residential property insurer. Goldman Sachs is lead manager, with Chase Securities, Lufkin & Jenrette Securities Corporation, and Zurich Capital Markets Securities, Inc. as co-managers. (1998)

**Allianz A.G. Holdings** - Issued a \$150 million catastrophe bond option to cover European catastrophe risks. The bond option gives Allianz the right to issue notes at a fixed rate any time over a three-year period to fund \$150 million of reinsurance coverage through Gemini Re, a Cayman Islands special purpose reinsurer. The bond allows Allianz to hedge its future cost of reinsurance. If traditional reinsurance costs rise after windstorm losses, the company might find it more cost effective to exercise the option to issue notes. Goldman Sachs placed the notes. (1998)

**Hannover Re** - Secured commitments for \$50 million in options for risk securitization of catastrophe losses. The option was placed with North American institutional investors and was amended to a November 1996 transaction. (1998)

**XL Mid Ocean Re** - Placed a \$200 million retrocessional property catastrophe cover. The transaction covers the upper layers of XL Mid Ocean Re's hurricane and earthquake exposure in the U.S. and its territories and possessions in the Caribbean. The deal provides retrocessional cover in the form of a swap in which claims recovery is triggered by catastrophe losses incurred by XL Mid Ocean Re. (1998)

**Horace Mann Educators Corporation** - Agreement involving a \$100 million transaction with Center Re. The transaction was managed by Aon Capital Markets. (1999)

**Constitution Re** - Transferred its East and Gulf Coast hurricane risk to Arrow Re. The risk was spread through a series of securitization and risk-transfer transactions. The transaction involved a \$10 million risk transfer. Goldman Sachs, Swiss Re New Markets and E.W. Blanch Capital Markets served as advisors. (1999)

**St. Paul** - Completed a \$45 million securitization transaction. The transaction provides additional capacity for a dined portfolio of U.S. property catastrophe excess-of-loss reinsurance contracts. Mosaic Re II issued the debt securities for the securitization. (1999)

**Kemper** - Acquired \$100 million of earthquake coverage. The capital markets transaction funds a fully collateralized reinsurance agreement providing \$100 million of Midwest earthquake coverage to the Kemper Insurance Companies. The transaction was managed by Aon Capital Markets. (1999)

**Sorema** - Issued a three-year \$17 million deal to protect its European windstorm exposures and Japanese typhoon and earthquake risks. The bonds have an annually renegotiable interest rate and allow Sorema to adjust the size of the coverage and the premium to meet market conditions. Merrill Lynch and Aon Capital Markets arranged the transaction. (1999)

**Oriental Land Company** - The owner of Tokyo Disneyland, Oriental Land Company, has placed two catastrophe bonds totaling \$200 million to protect against earthquake risk. In the first bond, Concentric Ltd. would pay Oriental Land \$100 million upon the occurrence of an earthquake that meets certain trigger conditions. The second bond provides Oriental Land with a \$100 million post earthquake financing facility. Goldman Sachs and Company was the placement agent for both transactions. (1999)

**USAA** - Acquired \$200 million in catastrophe reinsurance from Residential Reinsurance Limited. The proceeds of the sale of the bond were segregated into a trust to pay USAA's claims in excess of \$1.0 billion arising from a category 3, 4, or 5 storm on the Saffir-Simpson index. The placement was co-managed by Goldman Sachs & Company, Lehman Brothers Holding and Merrill Lynch. (1999)

Prepared by RAA, updated July 1999

P:\USERS\CM\WP\CATSS\SECURITIZATION\PLYER



**Independent Insurance Agents**  
**of**  
**America**  
Incorporated

---

**TESTIMONY OF:**  
**DONALD E. BEERY**  
**EUSTIS INSURANCE AGENCY**  
**PRESIDENT**  
**INDEPENDENT INSURANCE AGENTS OF LOUISIANA**  
**BEFORE THE HOUSE**  
**COMMITTEE ON BANKING AND**  
**FINANCIAL SERVICES**

---

**JULY 24, 1999**

**IIAA Capitol Hill Office**  
**Suite 300**  
**412 First Street, S.E.**  
**Washington, D.C. 20003**  
**(202) 863-7000**  
**Fax (202) 863-7015**

Statement

Donald Beery  
Eustis Insurance Agency

President  
Independent Insurance Agents of Louisiana

before the

House Committee on Banking and Financial Services

July 30, 1999

Mr. Chairman, thank you for the opportunity to testify this morning on behalf of H.R. 21, the Homeowners Insurance Availability Act of 1999.

My name is Don Beery and I am a partner in the Eustis Insurance Agency, located in New Orleans, Louisiana. I have been an insurance agent for more than 30 years, and the Eustis Agency has been serving the people of New Orleans for more than half a century. I also serve as the President of the Independent Insurance Agents of Louisiana. Our association is comprised of over 400 agencies with more than 3,500 agents and their employees who collectively write more than 300,000 homeowners policies.

I was asked today to give the Committee some sense of the problems in the Louisiana insurance market. I will provide a brief history of the situation as it has evolved in the state, the solutions that are currently in place and why a federal reinsurance program is critical.

Hurricane Betsy in 1965 was the last major storm to hit New Orleans. "Betsy" inflicted close to \$1 billion in property damage and killed 74 people in the affected area. By today's standards, "Betsy" was a moderate storm, but it was the first storm of any

consequence to hit our area in a long time and made insurers extremely nervous. Almost overnight, insurance companies pulled out of the market in coastal areas south of the Intracoastal Waterway. For those unfamiliar with Louisiana, this is a marshy, rather sparsely populated area. Few people lived in this area in 1965 and the same is true today. Therefore, the impact of the insurance pullback was not very great. Approximately 7,000 residents were affected. To deal with the problem of insurance availability, the insurance department authorized creation of the Louisiana Coastal Plan, a state-mandated insurance pool. The size of the Coastal Plan has changed little over the last 30 years. It is a classic "pool-of-last-resort" for a relatively small group of policyholders.

The second storm which had a profound effect on the Louisiana insurance market was Hurricane Andrew in 1992. Most people remember that Andrew devastated South Florida. However, once Andrew exited the Florida peninsula, it entered the Gulf of Mexico and eventually made landfall again in parts of Louisiana and Mississippi. Andrew caused only moderate damage in our state, since it missed New Orleans and had already begun to lose strength before it hit land. However, even though the damage was modest, the storm had a major impact on the insurance market.

Almost overnight, we began having trouble placing and renewing homeowners business. All agencies in our geographic area experienced similar problems. Eventually, the Louisiana Insurance Department authorized that the business which insurance companies refused to write could be placed into an insurance pool unrelated to the Coastal Plan known as the Louisiana Fair Plan.

The Fair Plan was originally established to provide coverage in certain urban and rural areas that were not adequately served by insurance companies. Like the Coastal Plan, it was a relatively modest program. However, because of the widespread insurance availability problems after Andrew, the insurance department authorized the Fair Plan to accept applications from homeowners south of Interstate 10 who could not obtain private insurance coverage.

Whereas the Intracoastal Waterway, which is the line of demarcation for the Coastal plan, is very close to the Gulf of Mexico. Interstate 10 extends inland more than 50 miles and travels through major cities including New Orleans, Baton Rouge and Lafayette.

Opening the Fair Plan to homeowners in this region had huge implications. The number of applications soared almost immediately. Between 1993 and 1997, the Fair Plan grew by more than 750%. The growth continues today, nearly a decade after Andrew, at a rate of more than 1,000 policies every month.

Since insurance companies who write coverage voluntarily in the state are responsible for the claims in the Fair Plan and the Coastal Plan, there is a great deal of concern about the escalating size of the pools and consequently their potential liabilities.

The Eustis Agency lives with the insurance availability problem every day even though homeowners insurance rates are considered adequate and are the second highest in the United States. Most of the companies we represent have placed severe restrictions on the number of new policies that we can place with them. Many insurers will only allow us to write one or two new policies a month. Some will only allow us to write three or four new policies a year! Several insurers will not write any policies for homes valued at more than \$100,000. Others will not write any policies on homes worth less than \$400,000. Many of our customers are caught in between. It is not unusual, for example, that the only source of insurance coverage we can find for a \$125,000 home is Lloyds of London. We do not feel that a homeowner with a \$125,000 mortgage belongs with Lloyds. Nevertheless, we have no alternative but to place them there.

I believe that a lot of the fear insurance companies are demonstrating today is a direct result of the hurricane "modeling" being done. A computer program simulates the effect of a worst-case storm on a certain area. The results tell insurers how large their losses would be based on the properties the company has insured. From that information, insurance companies develop their catastrophic plans ("Cat Plans") which are designed to limit exposures to certain levels. The companies instruct their local managers to

implement the plans, which in many cases require that they severely limit the sale of new policies or non-renew existing business.

All of the factors I have described lead me to believe in the absolute need for a Federal reinsurance program. I don't pretend to understand the actuarial pricing for a 100-year hurricane. What I do know is that a Federal program would allow for a more stable homeowners insurance marketplace.

I know that the Louisiana Insurance Department shares this view. Commissioner Brown has traveled to Washington in the past in support of reinsurance legislation and has written this week to express his support for H.R. 21.

I might point out that in the reinsurance community have tried to make an issue out of a task force report from the state which rejected the creation of a state insurance program similar to the Florida Catastrophe Fund. They have used this report to suggest there are no problems in Louisiana, or that the problems are exaggerated.

In fact, the report concluded that there were serious problems in the state, but the state already operated two residual market programs, the Coastal Plan and the Fair Plan. The task force concluded that creating a third plan was unnecessary, but in no way implied the problems were solved.

The study further recommended that a free-standing catastrophe reinsurance fund not be created at this time but that "the insurance department should continue to monitor and evaluate the operation of catastrophe funds in those states where they exist."

One reason Louisiana opted not to create a free-standing reinsurance fund was because the state's financial resources were so limited. Many other states are in a similar situation, which is why the triggers in H.R. 21 are critical. The triggers must take into account that the ability of a local insurance market to perform adequately is a function of population, the value of the property at risk and the insurance premiums which can be



collected. The current approach in H.R. 21 is correct, because it bases the trigger not on a fixed dollar amount which applies to all states regardless of size, but on each states' or regions' 1-in-100-year event threshold. It is the most equitable approach, and the least likely to discriminate against a particular state or region, either large or small.

In closing, Mr. Chairman, I would like to reiterate that the problems in Louisiana and other states are real. Over the last eighteen months, independent insurance agents from North Carolina, New Jersey, Missouri and Florida have all testified before this Committee, relaying their personal stories of persistent market availability problems. H.R. 21 is sorely needed. It will restore confidence in insurance markets, force more business back to private insurers and improve the quality of coverage for our customers. We urge you to act on the legislation as soon as possible.

Testimony of  
 Mary Fran Myers, Co-Director  
 Natural Hazards Research and Applications Information Center  
 University of Colorado  
 Boulder, Colorado

presented before  
 U.S. House of Representatives  
 Committee on Banking and Financial Services  
 Room 2128, Rayburn HOB  
 Washington, D.C.  
 July 30, 1999

Thank you for the opportunity to speak with you today.

I am the Co-Director of the Natural Hazards Center at the University of Colorado. The Center's mission for the past 24 years has been to bridge the gap between the hazards research community and the nation's practitioners who deal with hazards on a daily basis.

In May, we released the results of a federally funded, five-year, \$750,000 study involving 132 of the nation's hazards experts who took stock of knowledge in the physical and social sciences and engineering regarding natural hazards to answer the question, "Why, despite all our knowledge about the causes of, consequences from, and remedies for natural disasters, do losses from extreme environmental events continue to grow at an ever staggering rate?"

I am providing you each a copy of the Executive Summary of this study and will highlight only a few of our findings.

Losses from natural disasters are continuing to rise because our hazard reduction programs have been too narrowly focused on simple "loss reduction." They have failed to consider the complex and broad range of factors that contribute to disaster losses, specifically, elements within the earth's physical environment, among the nation's ever-changing demographic composition and distribution, and within the growing density of our built environment. These factors interact with one another to affect not only disaster resiliency, but other aspects of a sustainable society as well.

The conclusion of our study was that current loss reduction and mitigation programs are short-sighted and too reliant on technology. It is clear that these efforts, rather than reducing losses, are actually only postponing catastrophic losses to future generations.

Our study underscored that it is human beings and not nature who are the cause of disasters. Unless hazard loss reduction programs (be they proper land-use planning, disaster relief programs, building codes, or insurance programs) also take into consideration other basic aspects of sustainability such as economic vitality, environmental quality, and inter- and intra-

generational equity, they are doomed to fail.

Our study calls for a change in national culture regarding hazards in order to achieve a new way of dealing with extreme environmental events, which we call "sustainable hazard mitigation." In order to make that approach possible, several extraordinary actions are required, some of which are being initiated right now. For example, the Federal Emergency Management Agency is providing leadership through its "Project Impact" program by facilitating consensus-based networks in communities where citizens are determining which disaster losses are acceptable, which are not acceptable, and how they will pay for them in the future. In other words, they are working on "designing their future disasters."

This is but one step of several recommended by our project. There are two others I want to mention specifically.

One is the need to measure progress and evaluate current mitigation programs. For example, the National Flood Insurance Program—arguably the nation's largest mitigation program—has been in operation for 31 years, yet its effectiveness has never been thoroughly appraised. We only know that floods continue to cause the most losses of any hazard in the nation.

Second, we are calling for a holistic government framework. To facilitate sustainable hazard mitigation, all policies and programs, especially at the federal level, should be integrated and consistent. To establish a new national policy that affects hazard mitigation without considering its impacts on our complex society and the broad range of other mitigation strategies simply continues the "band-aid approach to dealing with disaster problems" this country has traditionally pursued. Our study determined, however, that disasters are not "problems." Rather they are a symptom of broader and more basic problems. Losses from hazards result from short sighted and narrow conceptions of the human relationship to the natural environment.

Thank you for the opportunity to speak. I would be happy to answer any questions and also want to volunteer to you the resources of our Center as you continue consideration of this bill.

DISASTERS BY DESIGN

*A Reassessment of Natural Hazards in the United States*

Dennis S. Mileti

University of Colorado at Boulder

with the contributions of participants in the Assessment  
of Research and Applications on Natural Hazards

*An Activity of the International Decade for Natural Disaster Reduction*

JOSEPH HENRY PRESS | WASHINGTON, D.C. | 1999



A quarter-century ago geographer Gilbert F. White and sociologist J. Eugene Haas published a pioneering report on the nation's ability to withstand and respond to natural disasters. At that time, research on disasters was dominated by physical scientists and engineers. As White and Haas pointed out in their *Assessment of Research on Natural Hazards*, little attempt had been made to tap the social sciences to better understand the economic, social, and political ramifications of extreme natural events.

White and Haas attempted to fill this void. But they also advanced the critical notion that rather than simply picking up the pieces after disasters, the nation could employ better planning, land-use controls, and other preventive and mitigation measures to reduce the toll in the first place. Today, at long last, public and private programs and policies have begun to adopt mitigation as the cornerstone of the nation's approach to addressing natural and technological hazards.

The 1975 report also had a profound impact by paving the way for an interdisciplinary approach to research and management, giving birth to a "hazards community"—people from many fields and agencies who address the myriad aspects of natural disasters. Hazards research now encompasses disciplines such as

climatology, economics, engineering, geography, geology, law, meteorology, planning, seismology, and sociology. Professionals in those and other fields have continued to investigate how engineering projects, warnings, land-use management, planning for response and recovery, insurance, and building codes can help individuals and groups adapt to natural hazards, as well as reduce the resulting deaths, injuries, costs, and social, environmental, and economic disruption. These dedicated people have greatly improved our understanding of the physical processes underlying natural hazards and the complexities of social decision making before, during, and after disasters. Yet troubling questions remain about why more progress has not been made in reducing dollar losses.

One central problem is that many of the accepted methods for coping with hazards have been based on the idea that people can use technology to control nature to make themselves safe. What's more, most strategies for managing hazards have followed a traditional planning model: study the problem, implement one solution, and move on to the next problem. This approach casts hazards as static and mitigation as an upward, positive, linear trend.

But events during the past quarter-century have shown that natural disasters and the technological hazards that may accompany them are not problems that can be solved in isolation. Rather, they are symptoms of broader and more basic problems. Losses from hazards—and the fact that the nation cannot seem to reduce them—result from shortsighted and narrow conceptions of the human relationship to the natural environment.

To redress those shortcomings, the nation must shift to a policy of "sustainable hazard mitigation." This concept links wise management of natural resources with local economic and social resiliency, viewing hazard mitigation as an integral part of a much larger context. Many aspects of this strategy were implicit in the recommendations formulated by White and Iwas a quarter-century ago.

But to head off the continued rise in tolls from disasters, those principles must become more explicit. This summary, and the report on which it is based, reflect the efforts of over a hundred experts who have worked and debated since 1994 to take stock of Americans' relationship to hazards past, present, and—most importantly—future. Those contributions have been used to outline a comprehensive approach to enhancing society's ability to reduce the costs of disaster.

#### THE ROOTS OF THE PROBLEM

Many disaster losses—rather than stemming from unexpected events—are the predictable result of interactions among three major systems: the physical environment, which includes hazardous events; the social and demographic characteristics of the communities that experience them; and the buildings, roads, bridges, and other components of the constructed environment. Growing losses result partly from the fact that the nation's capital stock is expanding, but they also stem from the fact that all these systems—and their interactions—are becoming more complex with each passing year.

Three main influences are at work. First, the earth's physical systems are constantly changing—witness the current warming of the global climate. Scientists expect a warming climate to produce more dramatic meteorological events such as storms, floods, drought, and extreme temperatures. Second, recent and projected changes in the demographic composition and distribution of the U.S. population mean greater exposure to many hazards. The number of people residing in earthquake-prone regions and coastal counties subject to hurricanes, for example, is growing rapidly. Worsening inequality of wealth also makes many people more vulnerable to hazards and less able to recover from them. Third, the built environment—public utilities, transportation systems, communications, and homes and office buildings—is growing in density, making the potential losses from natural forces larger.

Settlement of hazardous areas has also destroyed local ecosystems that could have provided protection from natural perils. The



draining of swamps in Florida and the bulldozing of steep hillsides for homes in California, for example, have disrupted natural runoff patterns and magnified flood hazards. And many mitigation efforts themselves degrade the environment and thus contribute to the next disaster. For example, levees built to provide flood protection can destroy riparian habitat and heighten downstream floods.

Another major problem has become clear over the past 20 years: some efforts to head off damages from natural hazards only postpone them. For example, communities below dams or behind levees may avoid losses from floods those structures were designed to prevent. But such communities often have more propensity to lose when those structures fail, because additional development occurred that counted on protection. Such a situation contributed to catastrophic damage from the 1993 floods in the Mississippi basin. And many of the nation's dams, bridges, and other structures are approaching the end of their designed life, revealing how little thought their backers and builders gave to events 50 years hence. Similarly, by providing advance warnings of severe storms, this country may well have encouraged more people to build in fragile coastal areas. Such development, in turn, makes the areas more vulnerable by destroying dunes and other protective natural features.

#### FOSTERING LOCAL SUSTAINABILITY

Sustainability means that a locality can tolerate—and overcome—damage, diminished productivity, and reduced quality of life from an extreme event without significant outside assistance. To achieve sustainability, communities must take responsibility for choosing where and how development proceeds. Toward that end, each locality evaluates its environmental resources and hazards, chooses future losses that it is willing to bear, and ensures that development and other community actions and policies adhere to those goals.

Six objectives must simultaneously be reached to mitigate hazards in a sustainable way and stop the national trend toward increasing catastrophic losses from natural disasters.

- *Maintain and enhance environmental quality.* Human activities to mitigate hazards should not reduce the carrying capacity of the ecosystem, for doing so increases losses from hazards in the longer term.
- *Maintain and enhance people's quality of life.* A population's quality of life includes, among other factors, access to income, education, health care, housing, and employment, as well as protection from disaster. To become sustainable, local communities must consciously define the quality of life they want and select only those mitigation strategies that do not detract from any aspect of that vision.
- *Foster local resiliency and responsibility.* Resiliency to disasters means a locale can withstand an extreme natural event with a tolerable level of losses. It takes mitigation actions consistent with achieving that level of protection.
- *Recognize that vibrant local economies are essential.* Communities should take mitigation actions that foster a strong local economy rather than depend on one.



#### Disaster Losses Are Growing

From 1975 to 1994, natural hazards killed over 24,000 people and injured some 100,000 in the United States and its territories. About one-quarter of the deaths and half the injuries resulted from events that society would label as disasters. The rest resulted from less dramatic but more frequent events such as lightning strikes, car crashes owing to fog, and localized landslides. • • • The United States has succeeded in saving lives and reducing injuries from some natural hazards such as hurricanes over the last two decades. However, casualties from floods—the nation's most frequent and injurious natural hazard—have failed to decline substantially. And deaths from lightning and tornadoes have remained constant. Meanwhile injuries and deaths from dust storms, extreme cold, wildfire, and tropical storms have grown. • • • The dollar losses associated with most types of natural hazards are rising. A conservative estimate of total dollar losses during the past two decades is \$200 billion (a 1994 dollar). More than 80 percent of these costs stemmed from climatological events, while almost 10 percent resulted from

earthquakes and volcanoes. Only 17 percent were insured. Determining losses with a higher degree of accuracy is impossible because the United States has not established a systematic reporting method or a single repository for the data. Further, these numbers do not include indirect costs such as downtime for businesses, lost employment, environmental damage, or emotional effects on victims. Most of these losses result from events too small to qualify for federal assistance, and most are not insured, so victims must bear the costs. . . . Seven of the ten most costly disasters—based on dollar losses—in U.S. history occurred between 1989 and 1994. In fact, since 1989 the nation has frequently entered periods in which losses from catastrophic natural disasters averaged about \$1 billion per week. The dramatic increase in disaster losses is expected to continue.

Many of the harshest recent disasters could have been far worse: had Hurricane Andrew been slower and wetter or torn through downtown Miami, for example, it would have wreaked devastation even more profound than the damage it did inflict. And the most catastrophic likely events, including a great earthquake in the Los Angeles area, have not yet occurred. Such a disaster would cause up to 5,000 deaths, 15,000 serious injuries, and \$240 billion in direct economic losses.





studies on this important yet elusive topic are required. Research on the impact of various types of mitigation programs on the immediate future, intermediate term (three to five years) and longer term (more than five years) of the economy of metropolitan areas<sup>1</sup> is required. Researchers also need to investigate the demographic differences that might exist in determining the impact of disaster mitigation and how they differ for disaster and non-disaster areas. Research for example, on minorities and households with higher socioeconomic status has been scarce. Low-income households are at greater risk simply because they live in lower-quality housing and because disaster insurance is rarely available. The need for mitigation and response efforts that acknowledge the demographic differences among the nation's citizens will become even more critical as the U.S. population becomes more diverse. Research is also needed to shed further light on how mitigation programs ranging from public education to disaster relief can be rendered equitable.

[illegible][illegible]

More than 100,000 people were employed, significantly and improvements in short-term forecasts... Automation is... have dramatically reduced the loss of life and injury in... systems more uniform, developing a comprehensive model for... information in real-time along with technical assistance. Better... of these need future advances in technology... not significantly limit damage to the... term warning systems are... intelligent... from disasters. Long range forecasts that help



define the risks to local communities years to decades ahead of potential hazards could assist local decision makers in designing their communities to endure them.

**ENGINEERING AND BUILDING CODES** The ability of the built environment to withstand the impacts of natural forces plays a direct role in determining the casualties and dollar costs of disasters. Disaster-resistant construction of buildings and infrastructure is therefore an essential component of local resiliency. Engineering codes, standards, and practices have been promulgated for natural hazards. Local governments have also traditionally enacted building codes. However, investigations after disasters have revealed shortcomings in construction techniques and code enforcement. Codes, standards, and practices for all hazards must be reevaluated in light of the goal of sustainable mitigation, and communities must improve adherence to them.

**INSURANCE** The public increasingly looks to insurance to compensate for losses from many types of risk-taking behavior. However, most property owners do not buy coverage against special perils, notably earthquakes, hurricanes, and floods. For example, nationwide only about 20 percent of the homes exposed to floods are insured for them. Many people assume that federal disaster assistance will function as a kind of hazard insurance; but such aid is almost always limited. And even when larger amounts are available, they are usually offered in the form of loans, not outright grants.

Insurance does help minimize some disruption by ensuring that people with coverage receive compensa-

tion for their losses as they begin to recover. The insurance industry could facilitate mitigation by providing information and education, helping to create model codes, offering financial incentives that encourage mitigation, and limiting the availability of insurance in high-hazard areas.

The industry already has problems providing insurance in areas subject to catastrophic losses because many insurers do not have the resources to pay for a worst-case event. Furthermore, the current regulatory system makes it difficult to aggregate adequate capital to cover low-frequency but high-consequence events.

**NEW TECHNOLOGY** Computer-mediated communication systems, geographic information systems (GIS), remote sensing, electronic decision-support systems, and risk-analysis techniques have developed substantially during the last two decades and show great promise for supporting sustainable hazard mitigation. For example, GIS models enable managers to consolidate information from a range of disciplines, including the natural and social sciences and engineering, and to formulate plans accordingly.

Remote sensing can be used to make land-use maps and show changes over time, feed information to GIS models, and gather information in the wake of disasters. Finally, decision-support systems can fill a gap in hazards management by analyzing information from core databases, including data on building inventories, infrastructure, demographics, and risk. The systems can then be used to ask "what-if" questions about future losses to inform today's decision making. Such systems are now constrained by the lack of comprehensive local data, but they will become more important as the process of evaluating and managing risk grows in complexity.



## ESSENTIAL STEPS

The shift to a sustainable approach to hazard mitigation will require extraordinary actions. Here are several essential steps: note that many initial efforts are already under way.

**BUILD LOCAL NETWORKS, CAPABILITY, AND CONSENSUS.** Today hazard specialists, emergency planners, resource managers, community planners, and other local stakeholders seek to solve problems on their own. An approach is needed to forge local consensus on disaster resiliency and nurture it through the complex challenges of planning and implementation.

One potential approach is a "sustainable hazard mitigation network" in each of the nation's communities that would engage in collaborative problem solving. Each network would produce an integrated, comprehensive plan linking land-use, environmental, social, and economic goals. An effective plan would also identify hazards, estimate potential losses, and assess the region's environmental carrying capacity. The stakeholder network especially needs to determine the amount and kind of damage that those who experience disasters can bear. These plans would enable policymakers, businesses, and residents to understand the limitations of their region and work together to address them. Full consensus may never be reached, but the process is key because it can generate ideas and foster the sense of community required to mitigate hazards.

This kind of holistic approach will also situate mitigation in the context of other community goals that,

historically, have worked against action to reduce hazards. Finally, the process will advance the idea that each locality controls the character of its disasters, forcing stakeholders to take responsibility for natural hazards and resources and realize that the decisions they make today will determine future losses.

Federal and state agencies could provide leadership in this process by sponsoring—through technical and financial support—a few prototype networks such as model communities or regional projects.

**ESTABLISH A HOLISTIC GOVERNMENT FRAMEWORK.** To facilitate sustainable mitigation, all policies and programs related to hazards and sustainability should be integrated and consistent. One possible approach toward this goal is a conference or series of conferences that enable federal, state, county, and city officials to reexamine the statutory and regulatory foundations of hazard mitigation and preparedness, in light of the principles of sustainable mitigation. Potential changes include limiting the subsidization of risk, making better use of incentives, setting a federal policy for guiding land use, and fostering collaboration among agencies, nongovernmental organizations, and the private sector.

Other efforts to foster a comprehensive government framework could include a joint congressional committee hearing, a congressional report, a conference by the American Planning Association to review experiences in sample communities, and a joint meeting of federal, state, and professional research organizations.

**CONDUCT A NATIONWIDE HAZARD AND RISK ASSESSMENT.** Not enough is known about the changes in our interactions among the physical, social, and constructed systems that are reshaping the nation's hazardous future. A national risk assessment should meld information from those three systems so hazards can be estimated interactively and comprehensively, to support local efforts on sustainable mitigation.

Local planning will require multi-hazard, community-scale risk assessment maps that incorporate information ranging from global physical processes to local resources and buildings. This information is not now available, and will require federal investment in research on risk-analysis tools and dissemination to local governments.

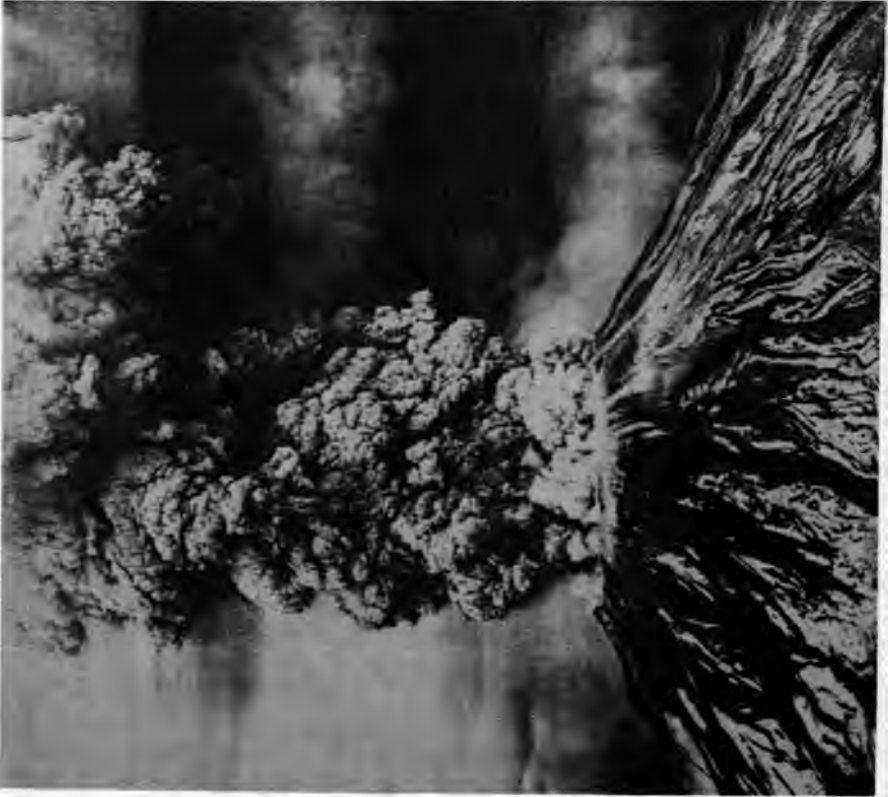
**BUILD NATIONAL DATABASES.** The nation must collect, analyze, and store standardized data on losses from past and current disasters, thereby establishing a baseline for comparison with future losses. This database should include information on the types of losses, their locations, their specific causes, and the actual dollar amounts, taking into account problems of double-counting, comparisons with gross domestic product, and the distinction between regional and national impacts. A second database is needed to collate information on mitigation efforts—what they are, where they occur, and how much they cost—to provide a baseline for local cost-benefit analysis. These archives are fundamental to informed decision making and should be accessible to the public.

A central repository for hazard-related social science data is also lacking. This third central archive would speed development of standards for collecting and analyzing information on the social aspects of hazards and disasters.

#### Emergency Preparedness and Recovery

Even if encouraged by more holistic state and federal policies, sustainable hazard mitigation will never eliminate the need for plans to address the destruction and human suffering imposed by disasters. In fact, one way to progress toward sustainable hazard mitigation is by creating policies for disaster preparedness, response, and recovery that support that goal. • • • A great deal of research has focused on pre-disaster planning and response since the 1975 assessment. Studies have found that pre-disaster planning can save lives and injuries, limit property damage, and minimize disruptions, enabling communities to recover more quickly. • • • Recovery was once viewed as a linear phenomenon, with discrete stages and end products. Today it is seen as a process that entails decision making and interaction among all stakeholders—households, businesses, and the community at large. Research has also shown that recovery is most effective when community-based organizations assume principal responsibility, supplemented by outside technical and financial assistance. An even further shift—away from an exclusive focus on restoring damaged structures toward effective decision making at all levels—may be needed. Outside technical assistance can

help strengthen local organizational and decision-making capacity. • • • Local leaders too often fail to take advantage of the recovery period to reshape their devastated communities to withstand future events. Most local disaster plans need to be extended not only to explicitly address recovery and reconstruction but to identify opportunities for rebuilding in safer ways and in safer places. • • • Fortunately, revisions to disaster legislation in the last several years have allowed greater percentage of federal relief monies to fund mitigation programs. Pre-disaster planning for post-disaster recovery is vital to communities' ability to become disaster resilient.



### A New Approach to Hazards

Researchers and practitioners in the hazards community need to shift their strategy to cope with the complex factors that contribute to disasters in today's—and especially tomorrow's—world. Here are the main guidelines for improving our ability to mitigate hazards.

- *Adopt a global systems perspective.* Rather than resulting from surprise environmental events, disasters arise from the interactions among the earth's physical systems, its human systems, and its built infrastructure. A broad view that encompasses all three of these dynamic systems and interactions among them can enable professionals to find better solutions.
- *Accept responsibility for hazards and disasters.* Human beings—not nature—are the cause of disaster losses, which stem from choices about where and how human development will proceed. Nor is there a final solution to natural hazards, since technology cannot make the world safe from ALL the forces of nature.
- *Anticipate ambiguity and change.* The view that hazards are relatively static has led to the false conclusion that any mitigation effort is desirable and will—in some vague way—reduce the grand total of future losses. In reality, change can occur quickly and nonlinearly. Human adaptation to hazards must become as dynamic as the problems presented by hazards themselves.
- *Reject short-term thinking.* Mitigation as frequently conceived is too short-sighted. In general, people have a cultural and economic predisposition to think primarily in the short term. Sustainable mitigation will require a longer-term view that takes into account the overall effect of mitigation efforts on this and future generations.
- *Account for social forces.* Social factors, such as how people view both hazards and mitigation efforts or how the free market operates, play a critical role in determining which steps are actually taken, which are overlooked, and thus the extent of future disaster losses. Because such social forces are now known to be much more powerful than disaster specialists previously thought, growing understanding of physical systems and improved technology cannot suffice. To effectively address natural hazards, mitigation must become a basic social value.
- *Embrace sustainable development principles.* Disasters are more likely where unsustainable development occurs, and the converse is also true: disasters hinder movement toward sustainability because, for example, they degrade the environment and undercut the quality of life. Sustainable mitigation activities should strengthen a community's social, economic, and environmental resiliency, and vice versa.

**PROVIDE COMPREHENSIVE EDUCATION AND TRAINING.** Today hazard managers are being called upon to tackle problems they have never before confronted, such as understanding complex physical and social systems, conducting sophisticated cost-benefit analyses, and offering long-term solutions. Education in hazard mitigation and preparedness should therefore expand to include interdisciplinary and holistic degree programs. Members of the higher education community will have to invent university-based programs that move away from traditional disciplines toward interdisciplinary education that solves the real-world problems ensnared in linking hazards and sustainability. This will require not only new degree programs but also changes in the way institutions of higher education reward faculty, who now are encouraged to do theoretical work.

**MEASURE PROGRESS.** Baselines for measuring sustainability should be established now so the nation can gauge future progress. Interim goals for mitigation and other aspects of managing hazards should be set, and progress in reaching those goals regularly evaluated. This effort will require determining how to apply criteria such as disaster resiliency, environmental quality, intra- and inter-generational equity, quality of life, and economic vitality to the plans and programs of local communities.

Also important is evaluating hazard-mitigation efforts already in place before taking further steps in the same direction. For example, the National Flood Insurance Program, which combines insurance, incentives, and land-use and building standards, has existed for 30 years, yet its effectiveness has never been thoroughly appraised.

Each disaster yields new knowledge relevant to hazard mitigation and disaster response and recovery, yet no entity collects this information systematically, synthesizes it into a coherent body of knowledge, and evaluates the nation's progress in putting knowledge into practice. Systematic post-disaster audits, called for in the 1975 assessment by White and Haas, are still needed.

**SHARE KNOWLEDGE INTERNATIONALLY.** The United States must share knowledge and technology related to sustainable hazard mitigation with other nations, and be willing to learn from those nations as well. Both here and abroad, disaster experts also need to collaborate with development

experts to address the root causes of vulnerability to hazards, including overgrazing, deforestation, poverty, and unplanned development. Disaster reduction should be an inherent part of everyday development processes, and international development projects must consider vulnerability to disaster.

#### THE KEY ROLE OF THE HAZARDS COMMUNITY

To support sustainable hazard mitigation, researchers and practitioners need to ask new questions as well as continue to investigate traditional topics. Important efforts will include interdisciplinary research and education, and the development of local hazard assessments, computer-generated decision-making aids, and holistic government policies.

Future work must also focus on techniques for enlisting public and governmental support for making sustainable hazard mitigation a fundamental social value. Members of the hazards community will play a critical role in initiating the urgently needed nationwide conversation on attaining that goal.

#### ACKNOWLEDGMENTS

This work to summarize knowledge and catalogue research and policy needs related to hazards and disasters in the United States was funded by the National Science Foundation under Grant Number CMS83-12847, with supporting contributions from the Federal Emergency Management Agency, the U.S. Environmental Protection Agency, the U.S. Forest Service, and the U.S. Geological Survey. The support of these agencies is greatly appreciated; however, only the author is responsible for the information, analyses, and recommendations contained in this summary.

Special appreciation is extended to the following people who served as members of the project's Advisory Panel:

William A. Anderson, National Science Foundation  
Michael Armstrong, Federal Emergency Management Agency  
Riley Chung, National Institute of Standards and Technology  
Caroline Clarke, National Research Council  
James F. Davis, California Division of Mines and Geology  
Walter Hays, U.S. Geological Survey  
Edward J. Hecker, U.S. Army Corps of Engineers  
William H. Hsieh, National Oceanic and Atmospheric Administration  
Robert Giesse, Colorado Office of Emergency Management

Richard Kriven, Federal Emergency Management Agency  
Eugene L. Loomis, Institute for Business and Home Safety  
James Martin, U.S. Environmental Protection Agency  
J. Eleanore Sabados, National Science Foundation  
James M. Swetland, U.S. Forest Service  
Kenneth R. Strath, U.S. Environmental Protection Agency  
Randall Updike, U.S. Geological Survey  
Gilbert F. White, University of Colorado at Boulder  
Arthur Zisiel, Federal Emergency Management Agency

Over a score of professionals reviewed the manuscript drafts of the book that this document summarizes. The greatest appreciation is extended to the reviewers for their insightful criticisms and recommendations. Warm appreciation also goes to David Morton, who lent his patience and willingness to serve as a personal librarian to every contributor to the project. Finally, Jacquelyn L. Morley edited the manuscript drafts without complaint—a Herculean effort. Jack, you will always have my deepest appreciation for your excellent work as an editor, and for your substantive contributions to the text as it emerged over several drafts. Mostly, thank you for taking on this project as your own and for your relentless commitment to it.



**Consumer Federation of America**

**H.R. 21  
"HOMEOWNERS' INSURANCE AVAILABILITY  
ACT OF 1999"**

**TESTIMONY OF**

**J. ROBERT HUNTER  
DIRECTOR OF INSURANCE**

**BEFORE THE COMMITTEE ON  
BANKING AND FINANCIAL SERVICES  
OF THE  
U.S. HOUSE OF REPRESENTATIVES  
JULY 30, 1999**



**STATEMENT OF J. ROBERT HUNTER<sup>1</sup>  
DIRECTOR OF INSURANCE,  
CONSUMER FEDERATION OF AMERICA<sup>2</sup>  
ON H.R. 21,  
"HOMEOWNERS' INSURANCE AVAILABILITY ACT OF 1999"**

**1. Introduction**

Good morning, Mr. Chairman and members of the Committee. I appreciate your invitation to testify today on the important topic of how the nation will deal with America's natural disasters in the next millennium.

**2. Current Reinsurance Situation Implies that no Bill is Necessary**

In the July 12, 1999 *National Underwriter*, Mr. Peter R. Pozzino, former Chief Operating Officer of Zurich Reinsurance Company and currently national director of Ernst & Young's insurance industry practice, opined that capital markets and securitization have placed a permanent cap on the pricing of catastrophe reinsurance. He said that the reinsurance industry wouldn't again see the hard turns that followed 1992's Hurricane Andrew and 1994's Northridge earthquake.

In the same article Weston Hicks, J. P. Morgan insurance analyst, was quoted as saying that the reinsurance industry is about \$75 billion overcapitalized.

---

<sup>1</sup> After serving in the private insurance industry as an actuary, Mr. Hunter joined the Federal Insurance Administration as Chief Actuary. He later became Administrator of the FIA, serving under Presidents Ford and Carter. He was founder and President of the National Insurance Consumer Organization, which he headed for 13 years. He served as Insurance Commissioner of the State of Texas during 1983 and 1984. Hunter has served as an advisor to the Florida Academic Task Force studying this problem. He has written extensively on this matter appearing in such diverse venues as the Journal of Insurance Regulation to the op-ed page of USA Today.

<sup>2</sup> CFA is a federation of some 240 pro-consumer and cooperative organizations with a combined membership of more than 50 million Americans.

Over to last year, the insurance trade press has article after article about the overcapitalized insurance and reinsurance market and the woes of the insurance companies trying to keep prices up in the "soft" market. Even the catastrophe reinsurance market has been very "soft." Indeed, over the last three years, catastrophe reinsurance rates have fallen by more than one-third. This year rates are falling but "the catastrophic reinsurance market rate of decline has slowed", Porrino said in the above-quoted article.

USAA and other insurers have been protected by new, securities-market-based, reinsurance arrangements. It has been clear for some years now that this bill really only would effect State Farm and, maybe, Allstate Insurance Companies. These companies, through diversification, balance in their portfolios of risks insured and, in State Farm's case, massive overcapitalization, are no longer really in need of this bill either.

Thus, Mr. Chairman and members of the committee, the predicate for this bill may have been eliminated by the normal market forces at work. You are to be congratulated for your patience over the years, not overreacting to insurer pressure to enacting an unnecessary intrusion into this area being handled well by the private sector.

### 3. There is still need for consideration of the current system by Congress

The nation has the time to really do what is needed in the disaster insurance area: rationalize the system that is so inconsistent today. America has allowed its system for preparing and responding to natural disasters to grow in a haphazard way that inconsistently deals with natural disasters and which inadequately acts to save lives and property damage from natural hazards.

Consider the following inconsistent approaches to the three major hazards in America:

<u>HAZARD</u>	<u>MITIGATION REQUIREMENTS</u>	<u>INSURANCE FROM:</u>
FLOOD	Federal	Federal
WIND	State or local	Private (in Homeowners) Or through State Mandated Wind Pools.
EARTHQUAKE	State or local	Private (separate policy) or through State Facility

The lack of a consistent approach to these hazards leaves taxpayers exposed to disaster relief payments and, through clearly insufficient mitigation requirements and enforcement, results in unnecessary loss of life and property.

In the long run, given the nature of the competitive market in insurance, prices reflect risk. Insurance subsidies may exist in the very short run, but they are minimized by state regulatory practices which only allow small impact, if any, of disasters from other states. Exhibit 1 shows the disaster payouts by insurance companies by year over the past three decades. Exhibit 2 shows the premium loads by state for catastrophes.

But disaster relief payments involve cross subsidy from those not exposed to high risk to those who are exposed. There is no risk testing in the collection of federal taxes. For example, there is no surcharge on taxes for living in a high-risk area.

Exhibit 3 shows the FEMA/SBA disaster relief payments made by state from 1988 to 1996. California received \$13.1 billion in assistance, 46% of the national total. Florida, albeit Hurricane Andrew is in this time frame, received only \$2.5 billion, 9% of the national total over the period. This disparity occurs because Hurricanes are covered in the Homeowners and other fire-related insurance policies, but earthquake is not.

Consider the breakout of payments for insurance vs. disaster relief:

<u>Type of Disaster</u>	<u>Relief payouts</u>	<u>Private Insurance payouts</u>
Earthquake	35.4%	9.1%
Floods	15.6	0
Hurricanes	23.0	40.0
Severe Storms	12.6	4.1
Tornadoes	5.1	29.8
Ice/Snow	3.7	9.5

Insurance takes care of smaller wind events such as tornadoes almost completely. Insurance does a good job on large wind events, too. Thus, the relatively low need for disaster relief for damage from hurricanes compared with the large need for relief for the less insured hazard of earthquake.

State cross subsidies in disaster relief are apparent (See Exhibit 4). Exhibit 4A shows an estimate of the subsidy by state in dollars per household per year. The largest subsidies go to ND (\$104) and CA (\$100). The states paying most in are CT (\$63) and NJ (\$52). Florida had a relatively low subsidy \$22, considering that Hurricane Andrew occurred during the period of study. This is due to the people of Florida paying their own way with insurance premiums for wind.

### Approaching a Solution to the Nation's Crazy-Quilt Disaster "System"

The way to approach a solution to the above listed inconsistencies is by careful study. The nation needs the answers to such questions as:

- Given the current overcapitalized insurance and reinsurance markets and the ready availability of catastrophe reinsurance, do we really need to have a federal backup for any hazard? If so, should the program be limited to earthquakes?
- What form should the program take? USAA has proposed an idea deserving of study: a program of tax-deferred reserves to maintain catastrophe risk in the private sector while ensuring access to affordable insurance to consumers.<sup>3</sup>
- What states really need any federal back up? HR-21 implies that California and Florida are targets. Is there need for a program beyond these states?
- Insurance company reports indicate that the damage caused by Hurricane Andrew would have been 33% to 50% less if building codes then on the books were enforced. Perhaps national verification of building code enforcement would be remarkably useful. Should there be such code verification?
- What are the long-term ramifications of any bill? Where is the cost/benefit analysis? How does the mitigation component really work over time? When can the taxpayer reasonably expect to get off of the disaster relief cycle through this program?
- Does Iowa subsidize California more or less than Iowa does today under the current disaster relief approach? Who gets any subsidy and how much/how long? Who pays

---

<sup>3</sup> The feasibility of a program like this for consumers depends upon how the program is set up. We believe that a condition for such tax relief should be a requirement to provide insurance for disasters to consumers and have mitigation programs in effect to prevent creating any incentives for unwise construction. "Firewalls" would need to be constructed to ensure that tax-deferred reserves would be used only to fund claims from certain disasters and not for profits of other purposes. Consideration must also be given to mitigation, including use of some of the investment income on these reserves for mitigation purposes.

subsidy and how much/how long? Will the people who chose to inhabit high-risk zones ever fully pay their own way?

- As to mitigation, what are the state of the art standards that will be required? Who enforces it? Is just one standard required or should it vary by place? Should there be federal minima that must be met for a state or locality to qualify for federally backed insurance?
- What will any program adopted mean vis-à-vis new construction? Will new construction be controlled in high-risk areas? Or, will the program encourage new construction to be unwisely built by making insurance more available/affordable even if poorly built in high-risk zones?
- Should there be one plan for all catastrophic hazards or is the issue different coverage by coverage? How should the National Flood Insurance Program be integrated into the overall plan? What are the lessons from the NFIP that should be instructive in developing the overall plan? Have the actuarial rates really been self-sustaining during the life of the program?

Before the flood insurance program was enacted, Congress did the right thing. It undertook a feasibility study under the leadership of the National Academy of Sciences that carefully answered the questions that attended to the flood risk. This sort of impartial study of what sort of federal back-up, if any, is needed for this country's insurance industry for natural disaster, what appropriate mitigation measures should be employed, what other quid-pro-quos should be exacted to protect taxpayers and answers to many other fundamental questions.

The Wharton School is well into such an effort. This study should answer many of these and other important questions. The Committee should find out the status of the study and have Wharton testify prior to any action on the bill. This important study is nearing completion as to many aspects and some of the key questions can doubtless be addressed soon, if not now.

#### Moving toward a political solution

Naturally, the ultimate program for rationalizing the handling of catastrophes in America will require political compromise. If we can find the right balance of mitigation, tax-deferral, response, insurance, risk securitization and enforcement, we can devise a plan to pay for current natural disasters and plan for future ones in a way that demonstrates to the taxpayer in states such as Connecticut, New Jersey, New York, Massachusetts, Ohio, Pennsylvania, Texas and Illinois (among other states currently footing the cost of disaster relief) that they will be freed from today's cycle of higher and higher tax support of unwise construction in high risk areas of the country.

The nation needs a true system to handle natural disaster. It is time to develop it.

Problems with H.R. 21 as Drafteda) The Congressional Findings (Section 2) are not valid

There are several findings that the passage of time and facts on the ground has invalidated. Just two examples are:

- Reinsurance costs are falling, not rising anymore. Insurance is now readily available.
- The insurance industry is, by all observers' comments, severely overcapitalized, so the comment that there is a "lack of sufficient capacity" is demonstrably wrong.

b) Where's the promise of availability of insurance?:

There is no requirement that the industry sell any new coverage as a condition of access to the federal treasury for the reinsurance back up. It makes no sense to enact a federal program to back up only the policies already on the books of the insurance companies since, as is obvious, they are in place today with no taxpayer exposure.

c) Mitigation.

The mitigation sections of the bill are remarkably weak. I am led to understand that this is because the Committee does not want to allow any other Congressional Committee to have to act on the Bill, which would be the case if mitigation requirements were put into the Bill. If it is true that a "turf battle" is at the heart of the weak mitigation in this Bill, you should reconsider. Weak mitigation, coupled with lower cost, more readily available insurance, will not only cost taxpayers more in the future, it will cost lives.

**Examples of the weakness of the mitigation requirements are:**

- The need for a strong mitigation component for new construction is particularly important in any bill which will tend to make insurance more available or affordable. The reason is obvious: if insurance is available, a home built in a very high-risk area can get protection by insurance and, thus, is more likely to be built. Even with the flood insurance rate maps and supposed full actuarial rates for new construction, there has been building on barrier islands that is questionable and which likely would not have been built were it not for the federal insurance availability. Simply put: any program that encourages unwise new construction is dangerous both to taxpayers and to the lives of persons inhabiting such structures. The bill only waives at the new construction issue, by requiring the state in the state program part of the bill, to certify that "new construction insured by the program complies with applicable building, fire and safety codes." No standards are imposed. No improvement in the inadequate status quo is gained.
- The lack of clear standards for construction and no standards for enforcement. Some money (10% of investment income on the State program for coverage; a very weak adjustment allowed in reserve prices for the private part of the program that "takes into account any efforts that are being made to reduce losses") will be made available for mitigation but there is no direction on how these moneys will be used, except for the weak phrase that the "State, or appropriate local governments ... have in effect building, fire, and safety codes generally consistent with" FEMA guidelines. This will go nowhere to reduce losses. There must be clarity. If there is not, pressure from builders at the local level will continue to degrade any tough standards in place.

## EXHIBIT 1

DISASTER PAYOUTS BY INSURANCE COMPANIES IN THE U.S.A.

<u>YEAR</u>	<u>CAT LOSSES<sup>a</sup></u>	<u>YEAR</u>	<u>CAT LOSSES</u>
1965	\$ 694 Million	1981	714 Million
1966	111	1982	1,529
1967	327	1983	2,255
1968	135	1984	1,548
1969	256	1985	2,816
1970	450	1986	872
1971	174	1987	905
1972	215	1988	1,409
1973	376	1989	7,642
1974	696	1990	2,625
1975	514	1991	4,723
1976	271	1992	22,970
1977	423	1993	5,705
1978	646	1994	17,010
1979	1,703	1995	8,310
1980	1,177	1996	7,375

<sup>a</sup> Source: Property Claims Services Division of American Insurance Services Group, Inc. Actual payouts. These payouts include commercial insurance as well as insurance on homes.



## INS. CAT LOADS BY STATE

Exhibit 1

STATE	PREMIUM FACTORS (%)	STATE	PREMIUM FACTORS (%)
Hawaii	8.56	Virginia	0.95
Florida	7.73	Tennessee	0.93
South Car.	5.22	Minnesota	0.89
Kansas	4.51	Pennsylvania	0.84
Oklahoma	4.16	Oregon	0.76
California	3.49	Ohio	0.76
Texas	3.22	New York	0.76
Colorado	3.17	Maryland	0.7
Louisiana	3.07	Washington	0.62
Mississippi	2.94	New Jersey	0.62
Alabama	2.78	Maine	0.62
Nebraska	2.47	Vermont	0.61
Rhode Is.	2.32	Wisconsin	0.58
Arkansas	2.29	Alaska	0.55
North Car.	1.85	New Hampshire	0.43
Wyoming	1.75	Arizona	0.39
Delaware	1.75	Utah	0.35
Iowa	1.65	Michigan	0.29
Missouri	1.61	Idaho	0.21
South Dakota	1.45	Dist. of Col.	0.2
Georgia	1.42		
Kentucky	1.41		
Connecticut	1.31		
North Dakota	1.28		
West Virginia	1.27		
New Mexico	1.24		
Indiana	1.24		
Nevada	1.23		
Massachusetts	1.11		
Illinois	1.09		
Montana	0.97		

Source: New York Insurance Department  
Catastrophe  
Premium Reserve Factors,  
5/14/97  
(used unadjusted factor as proxy for  
costs)

FEMA/SBA  
TOTALS  
DISASTER  
RELIEF  
1988-96

## EXHIBIT 3

\$ MILLIONS STATE

13061.7	California	103.2	Oklahoma
2491.5	Florida	86.8	Arkansas
859.2	Illinois	55.2	Maryland
736.8	Texas	54.2	Connecticut
706.9	Georgia	53.3	Idaho
618.7	South Carolina	52.6	Maine
602.5	Missouri	35.8	Michigan
590	Louisiana	30.9	Nevada
511.1	North Carolina	21.3	Vermont
471.8	New York	20.5	Rhode Island
467.9	Iowa	17.2	Delaware
444.2	Washington	14.9	New Hampshire
425.8	Pennsylvania	14.5	Montana
410.5	Hawaii	8.5	New Mexico
304	Minnesota	8.2	Dist. of Col.
293.1	Alabama	4.8	Colorado
231.1	North Dakota	2.6	Utah
204.8	Oregon	0.4	Wyoming
195.9	Massachusetts		
186.3	Kentucky	28289.9	Countrywide
172.7	Nebraska		
164.6	Ohio		
163.3	South Dakota		
160	New Jersey		
154.4	Mississippi		
153.5	Kansas		
137.6	Arizona		
136.9	Virginia		
134	Wisconsin		
133	West Virginia		
130.1	Tennessee		
129.6	Alaska		
128.4	Indiana		

## EXHIBIT 4

**DISASTER RELIEF PAYMENTS AS A PERCENTAGE  
OF FEDERAL TAXES PAID - 1/1/88 TO 6/30/96**

STATE	DISASTER PAY AS A % OF TAX	STATE	DISASTER PAY AS A % OF TAX
North Dakota	2.9	Oklahoma	0.3
California	2.4	Maine	0.3
Hawaii	2.0	Arkansas	0.3
South Dakota	1.8	Arizona	0.3
South Carolina	1.5	Wisconsin	0.2
Louisiana	1.2	Tennessee	0.2
Iowa	1.2	Pennsylvania	0.2
Florida	1.1	Montana	0.2
Alaska	1.0	Massachusetts	0.2
Nebraska	0.8	Virginia	0.1
Missouri	0.8	Rhode Island	0.1
West Virginia	0.7	Ohio	0.1
Georgia	0.7	New York	0.1
Mississippi	0.6	New Jersey	0.1
Alabama	0.6	New Hampshire	0.1
Washington	0.5	Nevada	0.1
Oregon	0.5	Maryland	0.1
North Carolina	0.5	Indiana	0.1
Minnesota	0.4	Dist. of Col.	0.1
Kentucky	0.4	Delaware	0.1
Kansas	0.4	Connecticut	0.1
Illinois	0.4	Wyoming	0.0
Idaho	0.4	Utah	0.0
Vermont	0.3	New Mexico	0.0
Texas	0.3	Michigan	0.0
		Colorado	0.0
		Countrywide	0.7

Note: Taxes for 1/1/95 to 6/30/96 estimated  
to be at 1994 levels.

## EXHIBIT 4A

**ESTIMATED PER HOUSEHOLD' CROSS SUBSIDY  
BETWEEN STATES FOR DISASTER RELIEF 1/1/88 TO 6/30/94**

<b>STATE</b>	<b>SUBSIDY PER HOUSEHOLD</b>	<b>STATE</b>	<b>SUBSIDY PER HOUSEHOLD</b>
<b><u>12 STATES RECEIVE:</u></b>			
North Dakota	\$104.32	Vermont	-20.60
California	99.56	Montana	-21.76
Hawaii	74.38	Arizona	-21.81
South Dakota	52.00	Illinois	-22.74
South Carolina	31.73	Texas	-23.41
Iowa	25.69	New Mexico	-25.92
Alaska	24.95	Tennessee	-27.40
Florida	21.62	Pennsylvania	-27.42
Louisiana	20.19	Wisconsin	-28.91
Missouri	4.57	Indiana	-30.32
Nebraska	3.31	Utah	-30.48
West Virginia	0.10	Rhode Island	-31.22
		Ohio	-32.62
		Colorado	-34.66
<b><u>OTHER STATES PAY:</u></b>			
Georgia	-0.09	Virginia	-35.57
Mississippi	-2.36	Delaware	-36.06
Alabama	-5.75	Wyoming	-37.88
North Carolina	-8.07	Massachusetts	-38.11
Kentucky	-11.83	New York	-39.20
Oregon	-12.22	Michigan	-41.60
Idaho	-13.11	Nevada	-43.41
Arkansas	-13.86	New Hampshire	-43.65
Washington	-15.36	Maryland	-43.99
Kansas	-15.40	Dist. of Col.	-49.73
Maine	-16.75	New Jersey	-51.71
Oklahoma	-17.39	Connecticut	-62.61
Minnesota	-17.73		
		Countrywide	\$ 0.00

<sup>1</sup> Households estimated by dividing population of state by 2.7 persons per household

**STATEMENT**

**of**

**Jack F. Weber  
President**

**Home Insurance Federation of America**

**July 30, 1999**

**before the**

**House Committee on Banking and Financial Services**

**regarding**

**H.R. 21**

**The Homeowners Insurance Availability Act of 1999**

I would like to thank the Chairman and other members of the Banking Committee for the opportunity to testify in support of H.R. 21, the Homeowners Insurance Availability Act of 1999.

This is the second time in twelve months that the Committee is considering natural disaster legislation. Last July in the 105<sup>th</sup> Congress, the Committee successfully reported H.R. 219, the predecessor to H.R. 21, by a wide margin. It should be noted that the current bill is identical to last year's legislation and includes all amendments which were agreed to at last year's markup.

From today's testimony, as well as an 18-month record from six previous hearings before the Housing Subcommittee and the full Committee, we believe a persuasive case has been made for a federal reinsurance program.

The Committee has heard direct testimony from state regulators, local insurance agents, realtors, and insurance companies. The witnesses have provided first-hand accounts of

the problems experienced in Missouri, California, Louisiana, Florida, North Carolina and New Jersey regarding adequate insurance for homeowners exposed to hurricanes, earthquakes and similar natural perils.

Both the director of the California Earthquake Authority and the Chief Executive Officer of the Florida Catastrophe Fund have testified about the events which led legislators in their states to create disaster insurance programs. They have also described the limits of those programs, and specifically their inability to cover mega-catastrophes.

The record also includes testimony concerning a scarcity of private reinsurance to cover worst-case disasters. This "capacity gap" can best be described as an affordability problem. In simplest terms, the cost of capital – which governs the price of private reinsurance – is considerably higher than the premiums that can be collected from homeowners based on the actuarial probability of loss. As a result, there is a limit to how much reinsurance that primary insurers can realistically purchase.

I explained this dynamic in my own testimony before the Banking Committee last year. Rather than cover similar ground again, I would like to focus my remarks today on how H.R. 21 will complement and encourage further growth of private insurance markets.

Today, the fear of a mega-catastrophe, and the inability of insurance companies to adequately reinsure their exposures, is forcing insurers to either withdraw from catastrophe-prone markets, reduce coverage or place a moratorium on new underwriting.

Insurers are in the business of insuring earthquakes, hurricanes and other natural perils, but events of a certain size and intensity, coupled with high concentrations of people and property, turn manageable losses into unacceptable risks. The mere possibility of a worst-case outcome is enough to stifle growth.

A similar case in point is the market for mortgage-backed securities. A total collapse of the economy would be a cause of great concern to mortgage lenders, but more

importantly to investors in the secondary mortgage markets. Unchecked, this fear could seriously undermine investor confidence, thereby reducing supplies of capital and increasing borrowing costs for consumers.

In the case of mortgage markets, this fear of catastrophic loss is kept in check because of support from the U.S. government in the form of credit guarantees. The guarantees provide a measure of protection against economic calamity, which in turn promotes investor confidence and keeps the system operating at maximum efficiency. The result is the most robust private mortgage industry in the world, more affordable mortgage products and the highest percentage of homeownership in the Nation's history.

There is no difference between a financial catastrophe affecting the mortgage market and a natural catastrophe that does serious damage to insurance markets. The government should play a constructive role in both cases.

The bill is not a substitute for private coverage. It does not eliminate risk. Ninety-nine percent of all earthquakes, hurricanes and other natural perils are not even covered by the program. What the bill does, however, is provide a means for managing the 1% of exposures which present an unacceptably high risk that no insurance company or state enterprise can bear alone.

These are not risks that are routinely reinsured through private reinsurance companies and the capital markets. If they were, we would not have an insurance availability problem, state governments would not be worried about the precarious future of their own insurance programs and no one would be promoting a federal reinsurance plan.

Critics contend that the bill will inhibit the future growth of reinsurance products by the capital markets. We emphatically disagree.

For the current hurricane season, the capital markets actually did fewer deals of consequence than they did the year before. In fact, the most celebrated capital market

catastrophe offering in history, USAA's \$400 million hurricane cat cover for 1997, was cut by half this year with little fanfare. Capital market offerings are priced at comparable, if not higher rates as traditional reinsurance, which is why neither market shows any signs of significant growth. We do not believe the fundamental economics are likely to change in the years ahead, which is why we do not believe H.R. 21 poses a threat.

Nevertheless, H.R. 21 includes many provisions, most of which were included at the insistence of reinsurers, which assure that federal reinsurance will not compete with the private market's current offerings nor inhibit the private market's future growth.

- In Section 3, the bill restricts the authority of the Secretary of the Treasury to offering federal reinsurance contracts which *shall not displace or compete with the private insurance or reinsurance or capital markets*;
- In Section 6, the bill limits the eligibility of state programs for federal reinsurance to plans which *do not supplant coverage that is otherwise reasonably available and affordable in the private insurance market*;
- In Section 7, the bill authorizes private reinsurers to purchase federal reinsurance contracts, and further allows such contracts to be *transferable, assignable and divisible*. This means reinsurers can repackage federal contracts, creating a secondary market which should benefit reinsurance companies and their customers;
- In Section 8, the bill authorizes the Secretary of the Treasury to reduce the levels of federal reinsurance on an annual basis to take into account *changes in the capacity of the private insurance and reinsurance markets*, and further, in making such a determination, instructs the Secretary to set such levels *at an amount that ...does not displace or compete with the private insurance or reinsurance markets or capital markets*;



- Also in Section 8, the bill cuts the level of reinsurance by half from what was originally proposed, precluding the Secretary from offering contracts which represent *more than 50 percent* of eligible losses; and
- In Section 12, the bill contains a mandatory sunset for the federal program after ten years with the possibility of only one 5-year extension if private markets have not evolved sufficiently.

All of the changes I've just described were incorporated into last year's bill and they have been similarly included, verbatim, in H.R. 21.

They provide more than adequate assurances that reinsurers and capital markets will have ample opportunity to sell their current products and develop new capacity, if it is possible to do so.

In the meantime, however, H.R. 21 also assures there will be a reasonable backstop to state insurance programs that have tapped the present limits of private reinsurance and would otherwise be forced to prorate claims from consumers in a major hurricane or earthquake. Through regional auctions, the bill similarly provides additional reinsurance capacity to insurance markets that lack state programs but are nevertheless experiencing availability problems.

Before closing, I would like to make two additional points.

First, some are asking that the triggers for federal reinsurance be raised. The suggestion is to raise the threshold for eligible events from those likely to occur once a century to some less frequent period such as once every 250 years. We are flabbergasted by the concept. Two hundred and fifty years dates back to 1749, twenty-seven years *before* the Declaration of Independence. Using such a yardstick, we overlook the founding of the Republic, a civil war, two world wars, the invention of the steam engine, the cotton gin, the telephone, electric light, the automobile and manned flight. Over that same period,

Lewis and Clark discovered a route to the Pacific Ocean. San Francisco became a city and then was partly destroyed in a great earthquake. A hurricane killed 20,000 people in Texas. Chicago burned to the ground, and the New Madrid quake redrew the boundaries of three states and permanently changed the course of the Mississippi River.

Raising the triggers to a 250-year threshold is tantamount to no program at all, which is precisely why it is being promoted by the bill's opponents.

On a related issue, we feel the Committee erred last year when it reduced the level of federal reinsurance to 50% of eligible losses, even for extremely large disasters. This means that for events which are well beyond the limits of private reinsurance, the program still offers only half of a solution. This strikes us as shortsighted. In the largest events, private insurance markets will collapse, state programs will fail and many homeowners will not be fully compensated for their losses. Such a scenario calls for a full federal reinsurance benefit, not half-measures.

Considered in its entirety, however, H.R. 21 is a substantial accomplishment.

Private homeowners insurance, paid for by the people who live in harm's way, reduces the burden on taxpayers after a disaster and imposes costs on the homeowner which fairly reflect the risk of living in certain areas. It is in the public interest that the supply of this coverage is stable, predictable and efficiently priced. H.R. 21 will go a long way to assuring such stability and deserves your support.

We thank Chairman Leach for devoting the Committee's time to this important matter, and the Ranking member, Mr. LaFalce for his support as well. We would also like to express our gratitude to Representative Lazio and Representative McCollum for their hard work over the last 18 months and to nearly 100 members of Congress on both sides of the aisle who have already co-sponsored H.R. 21.

###

For More Info. Contact:  
Jack Weber 703-736-0994



## **The Case for a Federal Disaster Reinsurance Program**

---

HR 21: The Homeowners Insurance Availability Act

Home Insurance Federation of America (HIFA)  
June 1999

## The Case for a Federal Disaster Reinsurance Program

### What Natural Disasters Cost

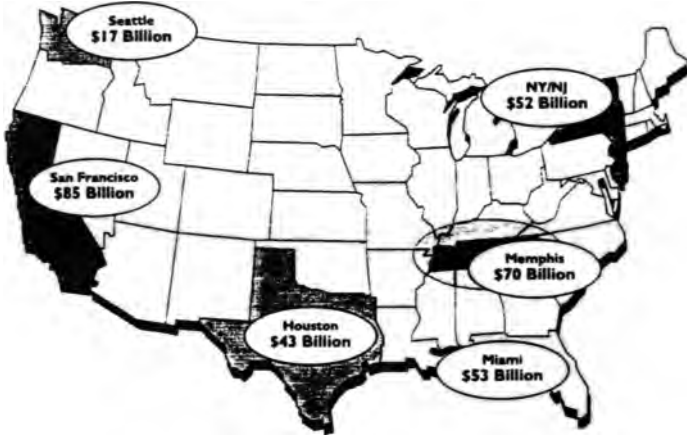
#### The Ten Costliest Insured Catastrophes in U.S. History

<b>Hurricane Georges</b>	1998	\$ 2.5 billion
<b>Hurricane Fran</b>	1996	\$ 1.6 billion
<b>Hailstorms</b>	1995	\$ 1.1 billion
<b>Hurricane Opal</b>	1995	\$ 2.1 billion
<b>Northridge Earthquake</b>	1994	\$12.5 billion
<b>Winter Storms</b>	1993	\$ 1.7 billion
<b>Hurricane Iniki</b>	1992	\$ 1.6 billion
<b>Hurricane Andrew</b>	1992	\$16.5 billion
<b>Oakland Fire</b>	1991	\$ 1.7 billion
<b>Hurricane Hugo</b>	1989	\$ 4.2 billion

Whether it is because of a changing global climate, a huge shift in population to coastal and earthquake-prone areas, or simply a string of bad luck, the United States has experienced an unprecedented rise in the severity and cost of natural disasters.

- Eight of the 10 most costly disasters in American history have occurred in the last 10 years.
- The two worst events, Hurricane Andrew (1992) and the Northridge Earthquake (1994) caused combined insured losses of more than \$28 billion.
- 1998 was the first time ever that there were four hurricanes simultaneously active in the Atlantic.
- More than 400 deaths were attributed to natural disasters in the United States during 1998, while Hurricane Mitch and the Colombian earthquake killed nearly 14,000 in Honduras, Nicaragua, El Salvador and Colombia.
- 1998 was the warmest year, worldwide, ever recorded.

## Potential Costs of Future Natural Disasters



### Disturbing Projections

Perhaps more disturbing than what has happened to date is what *may* occur in the years ahead. Scientists cannot say with precision when a particular event may happen, but they can make educated guesses based on historical records, probability analysis and modeling. They can also calculate the impact of an event by considering population density, real estate values, and the kind of construction typically found in a region.

- Projections for a worst-case event range from more than \$50 billion for a hurricane which strikes Long Island or Miami to more than \$70 billion for an earthquake in the New Madrid region (Missouri/Tennessee), and more than \$80 billion in Northern California.
- As massive as these projections sound, they are *conservative* estimates. In 1995, a moderate-sized earthquake that struck Japan's second largest city, Kobe, caused more than \$100 billion in damages.
- Scientists at the U.S. Geological Survey estimate that the San Francisco area has a 67 percent chance of a major quake by 2020. The last one in 1906 reduced most of the city to burning rubble.
- Hurricane Andrew, with sustained winds of 155 mph, *missed* population centers, as did Hurricane Camille in 1969. Camille battered a relatively sparsely populated shoreline in Louisiana, Alabama and Mississippi with winds over 200 mph and a 24-foot storm surge. Since a comparable event has never struck a major city, experts can only speculate on the likely damage.

## The Rising Costs of Natural Disasters

### Insurance Industry's Combined Ratio For Homeowners Insurance

YEAR	COMBINED RATIO*
1989	108.8
1990	107.8
1991	112.3
1992	155.6
1993	113.5
1994	117.9
1995	112.6
1996	121.7
1997	100.4

\*A combined ratio of 108.8 means that for every \$1 in premium collected insurers paid \$1.08 in claims and expenses. Conversely, a combined ratio of 98.4 means that for every \$1 in premium, the industry paid 98.4 cents in claims and expenses.  
Source: Insurance Information Institute

The rising cost of natural disasters has created a growing problem for the companies that insure America's homes. Natural disasters have seriously eroded the profitability of homeowners insurance coverage. The industry's combined ratio, the amount paid in claims and expenses compared to the premiums collected, has been negative in eight of the last nine years.

The largest homeowners insurance company in the United States, State Farm, lost more than \$3.5 billion in Hurricane Andrew, wiping out the company's nationwide surplus. The second largest homeowners insurance company, Allstate, lost \$1.9 billion in the same event, more than all the premiums the company had collected in the state of Florida over the previous 53 years.

The results were even more dramatic in California where insurers collected \$3.4 billion in earthquake insurance premiums from 1970 to 1994, yet paid \$12.5 billion in claims from the Northridge Earthquake in 1994.

### The Problem with Nature's Unpredictability

#### Actuarial Analysis of a Worst Case Disaster

IF AN EVENT IS LIKELY TO OCCUR...	IT WILL COST	THE ACTUARIAL PREMIUM FOR FUTURE LOSS SHOULD BE (excluding insurer expense and risk provisions)
Once every 10 years (10%)	\$100 million	\$10 million per year ( $\$100 \text{ million} \div 10$ )
Once every 500 years (0.2%)	\$20 billion	\$40 million per year ( $\$20 \text{ billion} \div 500$ )

The natural catastrophe problem is unlike problems that arise insuring other types of risk. Losses associated with life insurance, auto coverage or commercial liability are fairly stable and predictable. This allows insurers to factor expected losses into pricing coverage in a way that makes good business sense. By contrast, losses from major catastrophes are highly infrequent, but can be ruinous when they happen. This makes them extremely difficult to price accurately.

For example, in the illustration above, if a \$100 million disaster is expected to occur once every 10 years, the actuarial premium that should be charged is \$10 million ( $\$100 \text{ million} \div 10 \text{ years} = \$10 \text{ million/year}$ ). On the other hand, for an event that occurs once every 500 years and causes \$20 billion in losses, the actuarial premium is only \$40 million ( $\$20 \text{ billion} \div 500 \text{ years} = \$40 \text{ million/year}$ ).

This \$40 million dollars a year is more than sufficient, should the predicted event occur 500 years in the future. However, should the \$20 billion catastrophe occur *next* year, the \$40 million would be woefully inadequate.

Hence, the problem. No one knows for sure when the next colossal catastrophe will occur. Events like Hurricane Andrew or the Northridge earthquake are so much larger than the expected losses that are likely to occur in any given year that insurers cannot collect enough premium in a short enough time to pay all the losses.

---

The Case for a Federal Disaster Reinsurance Program

### Offering Products Consumers Want

Fifty or 100 years ago, the problem of natural disasters was not as critical to insurance companies. Most people did not live in coastal or earthquake-prone areas. Real estate values were relatively modest, and houses were constructed to better withstand the threats. Perhaps even more significant, insurance coverage was not offered for earthquakes, hurricanes and similar acts of nature.

Today, the situation is vastly different. The standard homeowners insurance policy—mandated by the housing credit markets—includes most natural disaster perils. (Flood insurance and earthquake coverage are separate policies that are added to standard coverage where applicable.)

The dilemma for insurers is how to offer a product that consumers want and real estate markets demand, but which is characterized by huge swings in profitability that in worst cases threatens the insurer's survival.



*Hurricane Andrew, 1992 (NOAA)*



## How Reinsurance Works

### Why the Traditional Reinsurance Process Isn't Working

#### Reinsurance Availability



The traditional tool that insurers have used to manage unpredictable risks is reinsurance, literally the insurance of insurance. In return for a percentage of the premium it collects, an insurer is able to transfer a portion of its risk to a reinsurance entity, which, in turn, is obligated to reimburse the insurance company for losses that exceed certain pre-determined levels. Reinsurance is a valuable financial tool, but there are limits to its usefulness, due to cost and availability.

- In practice, private reinsurance capacity in any given disaster-prone region of the United States is in the range of \$6 to \$10 billion.
- But, even this capacity is allocated among all lines of property exposure so that the amount available to cover *homeowners* insurance is closer to the range of \$3 to \$6 billion.
- There is simply not enough private reinsurance available for insurers to adequately manage the risk of worst-case disasters.

## Private Reinsurance has its Limits

### California Earthquake Authority: A Case Study

<b>Potential Exposure</b>	\$162 billion
<b>Total CEA Premiums</b>	\$783 million
<b>Reinsurance Purchased</b>	\$2.506 billion
<b>Total Cost of Reinsurance</b>	\$591 million
<b>Total CEA Claims-Paying Capacity</b>	\$7.2 billion

The limits of private insurance are best illustrated by the largest layer of reinsurance purchased anywhere in the world—the \$2.5 billion of coverage provided to the California Earthquake Authority (CEA). Established by the California legislature when the private market for earthquake coverage disappeared after the 1994 Northridge Earthquake, the CEA provides earthquake coverage to more than 75 percent of the state's homeowners insurance market.

The CEA collects an actuarially sound premium from consumers, which was \$783 million in 1997 and 1998 combined. This premium level reflects the best estimates from experts on the probability and cost of future disasters. Even though rates charged by the CEA are much higher than the private market rates before Northridge, the CEA spent 75 percent of its 1997 and 1998 gross revenues to purchase \$2.5 billion in reinsurance coverage. The CEA's claims-paying capacity stands at \$7.2 billion, so this reinsurance provides only 35 percent of the CEA's claims paying capacity.

---

The Center of Federal Reserve Bank of San Francisco

## How Reinsurance is Priced

### A Closer Look at a CEA Reinsurance Contract "The Warren Buffett Layer"

**\$1.075 billion of reinsurance coverage**

**\$115 million premium**

**1 percent risk of claim**

The differences between pricing reinsurance and primary insurance are dramatically illustrated by a closer examination of one of the CEA's reinsurance contracts.

Consider the deal between the CEA and financier Warren Buffett. Mr. Buffett sells the CEA slightly more than \$1 billion of reinsurance coverage, for which he charges an annual premium of \$115 million\*. That figure represents a return on his capital at risk of approximately 13 percent—a reasonable return and certainly not out of line considering his investment alternatives.

Buffet's 13 percent return, while justifiable by capital market standards, is high relative to the probability of a reinsurance claim. This risk is estimated at one claim per 100 years (1 percent). In other words, if the loss history of the CEA performs as expected, Buffet will theoretically earn \$115 million in premium each year for 99 years, plus additional investment income, while paying a \$1 billion reinsurance claim only once.

An insurance regulator would never allow an insurance company to charge rates to consumers based on the same premise, since doing so would amount to a premium that is more than 10 times the loss which can reasonably be expected to occur in any given year. The regulator would be more inclined to allow a primary rate equal to the \$10.75 million average loss, plus factors for reasonable operating expenses and profit.

The CEA example illustrates the problems faced in any property insurance market prone to low-frequency, high-cost disasters. Contrary to actuarial principles, limits are imposed by regulatory and market realities on the premium that can be collected from consumers for events that occur only rarely. Though regulatory and market constraints allow a premium that is more than sufficient to cover losses in most years, on very rare occasions a loss many times the statistical average can occur. Reinsurers are not willing to cover losses at these levels for anything less than a rate of return comparable to what could be earned in other investments. And, this rate of return is many times higher than what is being collected by the primary insurer. Consequently, the primary insurer can afford to reinsure only a small fraction of its worst-case exposure.

*\*The annual \$115 million premium was earned for coverage made available over a four-year period.*

*A fifth year has recently been added at \$94.5 million.*

### Private Reinsurance Can't Meet the Need

Some have suggested that new developments in the financial markets will someday supplant private reinsurance capacity. While there has been some progress to date, the number of financial market transactions have been few and the costs comparable to alternatives that have been around for years.




- Only one major catastrophe bond deal of any consequence has been transacted over the last two years—USAA's \$500 million cat bond offering—and no other deals have been structured by major homeowners' insurance companies.
- Activity in catastrophe futures at the Chicago Board of Trade has not grown significantly since 1992 because of the lack of sellers.
- Despite more than 300 listings posted at the Catastrophe Risk Exchange since 1996, the vast bulk of transactions has been small and inconsequential.
- Growth in "capital market natural catastrophe risk transfer" products is limited by the same forces plaguing traditional reinsurance sectors—the relatively high opportunity costs of capital compared to the manner in which primary insurance is priced.



*Hurricane Andrew, 1992 (NOAA)*

## Insurance Needs in Risk-Prone Regions

## Growth Markets of Last Resort Since 1992

Louisiana		+741%
Florida		+533%
California		+309%
South Carolina		+213%
North Carolina		+205%

By the year 2010, it is projected that 75 percent of the U.S. population will live within 60 miles of a coastline. Faced with the prospect of growing concentrations of people and property in risk-prone regions, the likelihood of even higher losses from future disasters and the inability of private reinsurance and capital markets to manage a greater proportion of the risk, insurers are seeking alternative ways to reduce exposures.

- State residual markets of last resort for homeowners unable to find coverage from insurance companies have grown at high rates through 1997. Figures for 1998, when they become available, are likely to show the trend continuing.
- In Florida, the collective value of properties covered by the state joint underwriting authority (JUA) is more than \$70 billion.
- In California, following the huge losses from the Northridge Earthquake, insurers that wrote 96 percent of the homeowners premiums in the state during 1995 stopped underwriting *any* new homeowners insurance policies, a situation only resolved by the creation of the CEA.
- In Hawaii, virtually the entire market for coverage against hurricanes disappeared in the aftermath of Hurricane Iniki, a situation remedied only by the creation of the Hawaii Hurricane Relief Fund.
- In North Carolina, the state hurricane "wind pool" has been expanded three times and now includes 18 counties of the state. The geographic boundary of the program now includes properties located as far as 70 miles from the Atlantic coastline.

### States Step in

Three states have intervened to prevent a complete meltdown in private homeowners insurance markets.

- In 1993, the Florida Legislature created the Florida Hurricane Catastrophe Fund, a state operated reinsurance mechanism that provides insurers a lower-cost, more comprehensive reinsurance backstop against hurricanes than is available in the private market. The Fund collects more than \$450 million per year from insurers doing business in the state. The assessments are placed in a state-managed, tax-exempt fund and held in reserve for claims from future storms.
- In 1994, the state of Hawaii created the Hawaii Hurricane Relief Fund, a state-managed entity that has become nearly the sole source of hurricane insurance coverage for homeowners in the state. The fund, which is publicly managed, relies on a combination of insurance industry assessments, user fees and private reinsurance to cover anticipated losses.
- In California, the Governor and state legislature enacted the California Earthquake Authority (CEA) in 1996, a state owned and operated venture which includes the voluntary participation of companies with total homeowners market share greater than 70 percent. The CEA provides insurance coverage for shake damage caused by earthquakes to any state resident wishing to buy the protection. The CEA relies on assessments from participating insurers of more than \$4 billion, plus private reinsurance and policyholder assessments to cover the bulk of expected losses.



*Temporary housing during the 1994 Northridge Earthquake  
(Federal Emergency Management Agency)*

**Capacity of State Insurance  
Programs Is Limited**

<b>California Earthquake Authority (CEA)</b>	<b>\$7.5 billion</b>
<b>Florida Catastrophe Fund (FCF)</b>	<b>\$16 billion</b>
<b>Hawaii Hurricane Relief Fund</b>	<b>\$1.75 billion</b>

It is important to emphasize that without state-backed programs, homeowners insurance markets in these regions would remain highly dysfunctional. Nevertheless, no state program has the financial resources, or a sufficient backstop from private reinsurers, to cover worst-case events.

- The Florida fund can presently cover a storm of approximately \$16 billion, which equates to an event likely to occur once every 70 years. A worst-case Florida storm is projected at nearly \$60 billion.
- The Hawaii fund can only cover a storm that causes losses of \$1.75 billion. By contrast, a worst-case storm that hits Honolulu is expected to inflict up to \$20 billion in losses. Policyholders with claims exceeding the capacity of the fund would receive prorated payments on their losses.
- In California, the CEA has the financial resources to cover up to a 400-year event (\$7 billion), but must pro-rate claims for losses that exceed these levels.

# Section 3

## Solutions to the Catastrophe Insurance Problem

### Options for Funding Natural Disasters



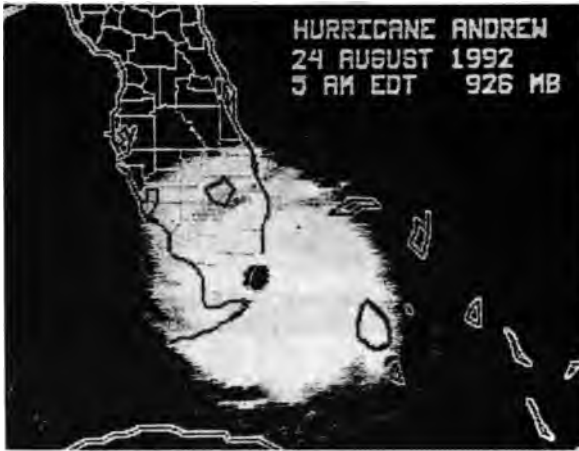
Individual property owners, insurance companies, capital markets, reinsurers, and state and local governments should all bear a certain amount of responsibility for future disaster costs.

- Insurance companies are in the business of helping consumers rebuild from the ravages of nature.
- Capital markets always seek profitable investment opportunities and reinsurers earn money by providing viable products that their insurance customers need and can afford.
- States and localities have taken steps to assure the availability of homeowners insurance where it would not otherwise be available.
- Consumers have been forced to assume a higher burden of disaster losses through higher premiums and less generous coverage.
- In Florida, homeowners insurance rates increased more than 80 percent from the date of Hurricane Andrew in 1992 until January 1997.
- In California, earthquake insurance deductibles are 15 percent. Coverage for contents, additional living expenses after a loss, and for unattached structures has been nearly eliminated, placing an increased burden on individual property owners.



But there are also limits to what any of these entities and consumers can do.

- Insurance companies cannot be expected to cover losses if, over the long run, the business is not profitable.
- Capital markets and reinsurers similarly cannot sell a product that does not return a profit commensurate with other investment alternatives.
- The tax base in any given state or community will never be large enough to shoulder the burden of a mega-catastrophe alone.
- There is a limit to what consumers can reasonably pay for coverage from an event that in all probability will not occur in their lifetime.
- If deductions are too large and prices too high, insurance no longer becomes a practical alternative for managing risk.



*Hurricane Andrew, 1992 (NOAA)*

## Option 1: Let Private Markets Handle It



*Hurricane Andrew, 1992 (NOAA)*

As a matter of public policy, what should we do? One alternative is to allow the private market to proceed as it has been doing. Under this scenario, the price of homeowners insurance will continue to rise, benefits will erode, and the trend towards reduced insurance market capacity will accelerate.

From an economic standpoint, these developments would be a logical reaction to a business model that does not appear viable in the face of the potential losses from a worst-case catastrophe.

If consumers cannot find appropriate insurance coverage, or if insurance companies do not wish to sell it, what is the harm?

- None at all, so long as major disaster losses do not occur.
- Realtors, mortgage lenders, insurance companies, reinsurers, state governments and consumers will all find a way to keep going while ignoring the possibility of a major event.
- Such was the case in Japan. After a devastating quake that nearly wiped out Tokyo in the 1920's, insurance companies generally abandoned the market, the government was content with the status quo and there was no uproar from consumers. All went well until 1995 when a major quake struck Japan's second largest city, Kobe. Losses totaled more than \$100 billion. Less than 1 percent of the loss was insured. The burden of rebuilding focused almost exclusively on devastated victims and the government of Japan.

### The Price of Doing Nothing

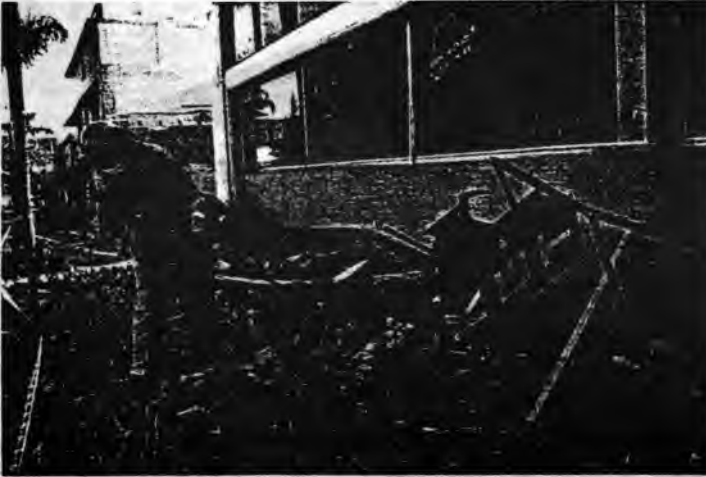


*Northridge Earthquake 1994 (Federal Emergency Management Agency)*

If we do nothing, no one will particularly notice or care *until* the inevitable happens. When it does, the cost of ignoring the problem will suddenly come due with interest.

- Insurers will fail in record numbers, leaving their customers with potentially unpaid claims.
- Guaranty funds, designed to protect against the occasional failure of an insurer will be overwhelmed, triggering even more defaults.
- Reinsurance will cover only a part of the loss, and following a historical pattern, the cost of reinsurance will explode, causing further contractions in the primary insurance market.
- State programs will be overwhelmed, leaving policyholders no right of redress and likely to be reimbursed for only a portion of their claims.
- Worst of all, those homeowners who could neither find adequate coverage or afford it will find themselves in the midst of a personal catastrophe from which they will have no means to recover on their own.
- Who will be called upon when there is no one left to take care of this mess? The federal government, of course.

### Why We Must Prep



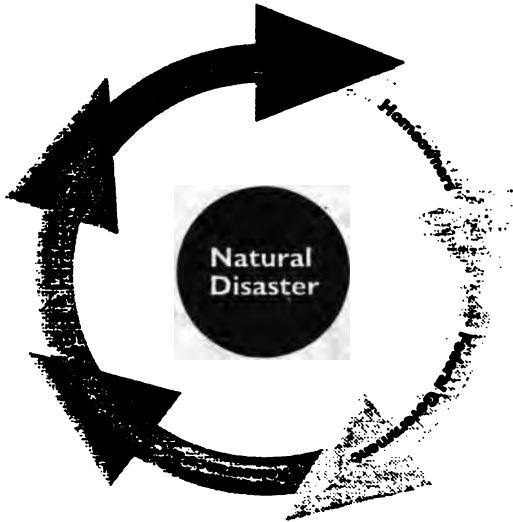
*Northridge Earthquake 1994 (Federal Emergency Management Agency)*

The President, the Congress and the American people will not tolerate a crisis with such a large and staggering human and economic toll. Indeed, much as it would if the attack had come from a missile or bomb, the federal government will immediately step into action, regardless of the cost.

This is as it should be, since it is precisely for such purposes that a federal government exists...to work in the public interest when there is no one better suited to perform the task. And yet, we pay a huge price for this "after-the-fact" solution.

- Because we have not prepared in advance, the costs will be much higher.
- Because the federal government cannot absorb the entire loss, many families will be ruined financially.
- The secondary effect on mortgage markets, banking and financial institutions and real estate values will be extremely severe.
- The private homeowners insurance market may be permanently ruined.
- And, the bulk of recovery costs will be borne nationally by taxpayers who live nowhere near the disaster site.

## Option 2: Federal Reinsurance

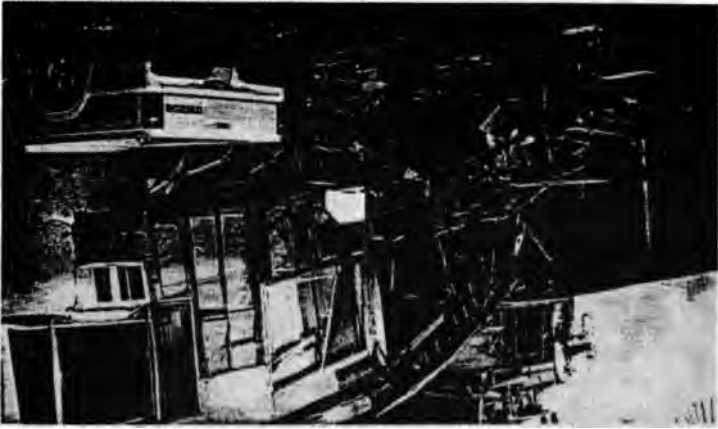


There is a better way. The federal government can encourage every other entity to take on as much of the burden as can reasonably be expected, and then, where there are gaps, use its unique power and capacity to finish the job.

- Insurers are more than able to cover the lion's share of losses from natural catastrophes. It is only the very large and extremely rare events that pose the problem.
- Reinsurers and capital markets are constantly evolving to serve their customers more efficiently. A portion of disaster losses will always be absorbed by these mechanisms.
- Where private insurance markets are not sufficient and reinsurance capacity inadequate, state insurance regulators are the logical first line of defense for consumers, and they have shown a willingness to respond when needed.
- Thus, it is only the rare and extremely large disaster that poses the problem. Leave this problem unresolved and the entire safety net crumbles for everyone. Insurers abandon markets. Consumers go without protection. Underfinanced state solutions are poised for failure.

## The HR 21 Solution

### What it is, How it Works



*Northridge Earthquake 1994 (Federal Emergency Management Agency)*

HR 21, the Homeowners Insurance Availability Act, is the logical answer to how the federal government can be responsive. This legislation seeks to encourage the private insurance industry, capital markets, reinsurers, state government, consumers and the federal government to collectively shoulder the burden of natural disaster risk.

It does this by ignoring the bulk of natural disasters, and stepping in only for those rare events that exceed the reasonable financial limits of market forces and state governments. For these catastrophic events, the federal government will *share* the risk by selling actuarially priced reinsurance that is either not presently available in the private marketplace or cannot reasonably be expected to be offered in the private marketplace in the foreseeable future.

## How It Would Work

---

### Determining the Cost

Under the provisions of HR 21, the Secretary of the Treasury would establish an advisory commission of actuarial experts to help determine prices for federal reinsurance. The secretary would have final pricing authority, except that the prices could not be less than levels recommended by the commission. There would be three components to pricing:

- **Risk-based price.** A sum that reflects the anticipated annualized payout of the contract according to actuarial analysis and commission recommendations, *plus*
- **Risk-load.** An amount that is not less than the risk-based price, *plus*
- **Administrative costs.** A sum sufficient to provide for the operation of the commission and the administrative expenses incurred by the Secretary.

### Federal Reinsurance for State Programs

Under HR 21, state-run programs such as the CEA, FHCF and HHRF would be able to purchase reinsurance coverage for events that exceed their claims-paying capacity. This means that the state's "retained losses"—the minimum amount it must pay out before federal reinsurance kicks in—would be based on an amount that is the greater of:

- \$2 billion
- The claims-paying capacity of the eligible state program as determined by the Secretary, or
- An amount determined by the Secretary that is sufficient to cover eligible losses in the state during a 12-month period for all events having a likelihood of occurring once every 100 years.

### A Scenario for Regional Auctions

In a regional auction, the trigger for federal reinsurance is tied to the residential insured loss likely to occur once every 100 years. Experts advising the Secretary of the Treasury would estimate the 100-year loss threshold in each region.

It is also up to the Secretary to determine how many contracts will be sold at each auction, and the states that will comprise a particular region. The law requires the Secretary to conduct at least six regional auctions per year, including separate auctions for the states of Florida and California.

The total payout cannot exceed \$25 billion per year from all contracts sold nationwide. If there were a particularly bad year, available funds would be distributed proportionately. However, the statistical probability of such an occurrence is in the range of 1/10,000.

## Establishing a Price

Let us assume that for the Pacific Northwest, the Secretary decides to auction 1,000 contracts, each with a value of \$20 million. For illustration purposes only, we will assume that a 100-year event in the region is \$4 billion. Here are the pricing steps:

- Using input from actuaries and other experts, the Secretary determines the number and severity of catastrophes that are anticipated to occur in the region above the 100-year threshold. There will be many years when there are no losses, and there may be one or two years when losses might be very large. The *average* of these losses is known as the *average annual loss (AAL)* and is the first step in determining a risk-based price for each reinsurance contract.

For our example, we will assume that the AAL in the Pacific Northwest for events that exceed \$4 billion is \$100 million per year. The risk-based price for each contract then becomes a simple calculation.

**Step One: Determine  
Risk-Based Price**  
\$100 million (AAL)  
+ 1,000 contracts  
**\$100,000 per contract**

- Next, the Secretary must add an additional charge or "load" in an effort to collect enough premium if a catastrophe occurs sooner than expected. This load factor must be at least as high as the AAL. Thus, the \$100,000 figure established in the first step is doubled to at least \$200,000.

**Step Two: Add Load**  
\$100,000 (from first step)  
+ \$100,000 (load)  
subtotal = **\$200,000**

- Finally, the Secretary adds an additional cost to reflect the administrative expense of running the federal reinsurance program. For illustrative purposes, we will assume these administrative costs add 5 percent to the cost of each contract, or approximately \$10,000. Therefore, the *minimum* bid price of each contract sold in the Pacific Northwest auction would be no less than \$210,000.

**Step Three: Add  
Administrative Costs**  
\$200,000 (from second step)  
+ \$10,000 (5% of subtotal)  
= **\$210,000**

Through the auction process, it is likely that the price of federal reinsurance contracts would rise as insurers, reinsurers and other investors competitively bid. Thus, while \$210,000 might be the opening price for each contract, it is possible that the final price would be considerably more.



### After a Catastrophe

To collect federal reinsurance, it would be necessary for a catastrophic event to occur in the Pacific Northwest during the one-year contract term, which causes losses that exceed the 100-year trigger threshold (\$4 billion).

For purposes of our example, let us assume that all the contracts have been sold, and an event occurs in the Pacific Northwest that causes \$7 billion in total residential insured losses. According to the calculations described below, the portion of the total loss eligible for federal reinsurance coverage would be \$3 billion:

$$\begin{aligned}
 & \$7 \text{ billion (insured losses from catastrophe)} \\
 & - \quad \underline{\$4 \text{ billion (trigger for federal reinsurance)}} \\
 & = \quad \$3 \text{ billion (losses eligible for federal reinsurance)}
 \end{aligned}$$

Each federal contract covers 50 percent of eligible losses—in this case, 50 percent of \$3 billion. So, since there were 1,000 contracts sold at auction, each contract would have a value of \$1.5 million based upon the following calculation:

$$\begin{aligned}
 & \$3 \text{ billion eligible losses} \\
 & \quad \times \underline{50\%} \\
 & = \quad \$1.5 \text{ billion (total payout for all federal contracts,} \\
 & - \quad \underline{1,000 \text{ contracts sold at auction)}} \\
 & = \quad \$1,500,000 \text{ payout per contract}
 \end{aligned}$$

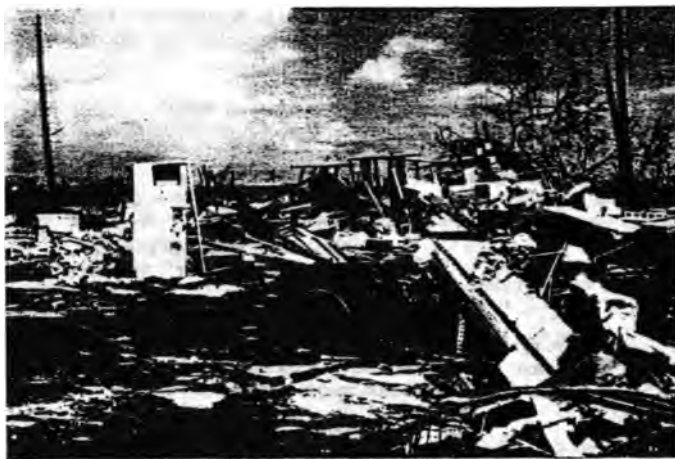
Using this example, an investor that purchased 100 contracts would be able to make federal reinsurance claims of \$150 million ( $\$1,500,000 \times 100$ ).



*Mount St. Helens, 1980. Photo courtesy of Mount St. Helens National Volcanic Monument.*

*The Standard and Poor's 500 Index, 1980-1981.*

## Safeguards to Encourage and Promote Private Markets



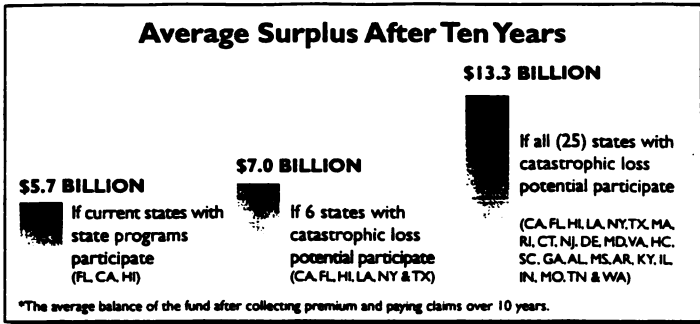
*Hurricane Andrew, 1992 (NOAA)*

The federal reinsurance offered by HR 21 is not intended to replace or compete with private insurance or reinsurance markets. In fact, it is hoped that the federal program will actually *encourage* the private market to absorb an even greater share of catastrophe exposures over time.

The best analogy might be federal backing of private mortgage securities. An unheard of concept thirty years ago, Congressional support led to a stable and thriving secondary market for mortgage-backed investments that has increased homeownership and the affordability of housing across the United States.

### Key Features:

- Reinsurance contracts sold at auction are fully transferable and divisible.
- The goal is to create an active secondary market that will ultimately attract new sources of investment capital.
- The Secretary of the Treasury cannot sell contracts at prices or levels of coverage that are duplicated in the private market.
- Federal reinsurance will only cover 50 percent of eligible losses, forcing those who buy the coverage to seek alternative sources to cover the balance of their risk.
- The program includes an automatic 10-year sunset provided new sources of capital develop to supplant federal coverage.

**Common-sense Approach**

H.R. 21 is a common sense approach to preparing for future disasters.

- It charges actuarially based premiums to those states and insurance markets where extreme future losses are most likely.
- Those premiums accumulate in a federal disaster trust fund that build over time (tax-free) in a manner that pre-funds possible future claims.
- When claims do occur, they are paid for from accumulated premiums, not general tax revenues. In this way, those at risk pay for their protection directly, instead of relying on taxpayers that do not live in risk-prone areas.
- Studies show that the federal reinsurance program is most likely to generate a federal budgetary surplus over time.

**Who supports H.R. 21?**

**Insurance Companies and Organizations:**

- State Farm Insurance
- Allstate Insurance
- Farmers Insurance
- SAFECO Insurance
- Met Life Auto & Home
- The Hartford
- Chubb Insurance
- Independent Insurance Agents of America
- National Association of Independent Insurers

**Financial and Real Estate Organizations:**

- Washington Mutual
- Western League of Savings Institutions
- National Association of Homebuilders
- National Association of Realtors
- Fannie Mae
- Freddie Mac

**Government Leaders:**

- Deputy Treasury Secretary Lawrence Summers
- Insurance Commissioners from New York, California, Florida, Louisiana, etc.
- House Banking Committee Chairman Jim Leach
- House Banking Committee Ranking Minority Member John LaFalce

---

## Q&A

### Frequently Asked Questions About HR 21

#### How do auctions work?

The Treasury will conduct at least six auctions per year. Each auction will target a part of the country prone to potentially catastrophic disasters.

For each region, the department will determine the appropriate level at which federal reinsurance will be available. This level or "index" will be defined for each region, but the Secretary is guided by certain requirements.

The index cannot be set at levels below which the probability of an event is 1 percent. In other words, federal reinsurance will only be available for events that occur less than once every 100 years. The index also cannot compete with levels of coverage typically offered in private reinsurance markets.

Once the regional index is established, the Secretary will set an appropriate minimum bid or reserve price for each contract. The Treasury Department will determine the precise number and denominations of contracts in a region, but the total value of *all* contracts cannot exceed \$25 billion. Interested parties, including insurance companies, reinsurers and other investors may submit bids above the reserve price for any of the contracts offered for sale.

If a catastrophe occurs in the region during the contract term and insured losses exceed the minimum levels established as the index, the owner of a reinsurance contract is entitled to payment according to a predetermined formula. That formula is designed to pay 50 percent of losses that exceed the index.

For example, Company "A" purchases a federal reinsurance contract for natural disasters that might occur in the region above an index of \$10 billion. An earthquake occurs that causes \$14 billion in insured losses. Consequently, the loss above the \$10 billion index is \$4 billion. Fifty percent or \$2 billion of this loss is covered by federal reinsurance, which is allocated proportionately among owners of federal reinsurance contracts including Company "A."

#### Why can state insurance programs buy directly from the federal government instead of participating in the auctions?

The public interest would not be served by state-governed entities competing with one another for a limited number of federal contracts. In addition, since states vary in population and disaster risk, certain states would be able to dominate the auctions at the expense of their smaller rivals.

### **Won't the bill encourage the proliferation of state programs?**

It is unlikely. Unless there is a private insurance market crisis, there is little incentive for a state to create a program. In fact, it is hoped that the regional auctions made available by the Treasury Department will obviate the need for additional state programs.

To date, only three states have created such plans, in large part because of the failure of the private homeowners insurance market. There are also certain eligibility criteria before a state program can qualify for federal reinsurance.

These include:

- A finding by state regulators that the program is necessary to provide continuing coverage for consumers.
- The program is operated as a not-for-profit, tax-exempt organization.
- All surpluses are retained for future events that may occur.
- Ten percent of the program's net income is used for programs that reduce the cost of future disasters.
- The program does not involve cross-subsidies.
- Premiums charged by the program reflect full actuarial costs.
- Publicly appointed representatives administer the program.
- Coverage made available by the program does not compete with coverage available in the private market.
- Coverage is available on a non-discriminatory basis.
- The state has building codes consistent with recommendations by FEMA.
- The state has laws to prohibit price gouging following a major disaster.

**Why not let disaster-prone states and insurance companies fend for themselves?**

This question is often posed rhetorically by asking, "What's in it for Wisconsin or Iowa?" The fact is that the biggest risk to U.S. taxpayers is the growing population of uninsured or underinsured homeowners in coastal areas and earthquake zones. That is because, if a large event does occur, uninsured victims will almost surely demand federal relief. Under such a scenario, taxpayers across America, regardless of where they live, will pay for this relief. It is far better to assure that insurance markets are functioning properly in these high-risk areas. Federal disaster assistance is directly offset by private insurance claims. A program that assures a solvent and well-functioning market in disaster-prone areas reduces the problem of uninsured victims demanding government handouts.

**What about the risk to taxpayers from capacity of the federal reinsurance program?**

Under HR 21, the regions most likely to need government assistance will be paying into a system to *pre-fund* a large share of the costs and preserve private insurance markets. Should losses occur that exceed the financial capacity of the federal reinsurance (highly unlikely since no event in U.S. history has yet to cause losses sufficient enough to trigger the program), the Treasury may issue bonds to raise sufficient capital, which must be repaid with interest from future premiums. This is far preferable to a "do-nothing" approach that will force the government to allocate funds through disaster relief programs which pose no possibility of being pre-funded or repaid.

**We heard that the insurance industry has a \$300 billion surplus. Why can't they cover these events out of their own pockets?**

The \$300 billion surplus figure applies to all types of insurance, not *homeowners* insurance. In fact, only about 10 percent of insurance industry premiums cover exposures to residential property. The truth is that the amount of surplus that can be reasonably allocated to residential property exposures is closer to \$30 billion than \$300 billion. And, this figure applies to policies sold throughout the United States. The amount of surplus backing insurers who write in specific parts of the country is much lower.



Hurricane Georges, 1998 (NOAA)

**A Brief Response to the  
Reinsurance Association of America's Testimony and "Fact" Sheet**

---

- RAA claims reinsurance rates have fallen.

This "fact" omits the larger truth that over the last ten years, reinsurance rates have risen a net 60%.

Rates rose 110% between 1990 and 1994. Rates declined 35.8% between 1995 and 1999. Rates will again surge following a major disaster. In fact, reinsurers are counting on it.

**Paragon Reinsurance Price Index**

	%Change	Index Number
1990	+ 9.7%	1.02
1991	+ 15.7%	1.18
1992	+ 19.5%	1.41
1993	+ 60.3%	2.26
1994	+ 4.9%	2.37
1995	- 2.2%	2.32
1996	- 7.8%	2.14
1997	- 13.3%	1.85
1998	- 10.2%	1.67
1999	- 2.3%	1.63

Net Increase  
( '90-99)                      + 61%

Source: Paragon Risk Management Services  
Survey of Reinsurance Prices

- RAA says there is \$20 billion of reinsurance sold per region of the U.S. This contention is inaccurate and misleading because it fails to account for several factors:

- 1) At least half this figure is for *commercial* exposures. The amount devoted to residential lines is much lower.

Using this logic the claim of "\$20 billion" must be reduced to \$10 billion.

- 2) The \$10 billion is further exaggerated because the numbers are double, triple and quadruple-counted.



**Example.** Allstate buys approximately \$500 million of reinsurance for their hurricane exposure in the Northeast. But since Allstate is a national company, RAA counts the \$500 million separately for each region in which Allstate does business. Thus, RAA credits the reinsurance industry with having provided Allstate \$500 million in every region of the U.S., even though there is no hurricane risk in these regions and the "coverage" is meaningless. Using RAA logic, \$500 million of legitimate hurricane catastrophe reinsurance is magically transformed into \$3 billion of nonexistent coverage.

In sum, relevant reinsurance capacity is overstated by half because of commercial lines coverage and greatly exaggerated by double and triple counting. The true capacity is between \$3 billion and \$5 billion.

- 3) RAA's exaggerations by several orders of magnitude are clearly demonstrated by the example of the California Earthquake Authority.

The CEA insures nearly all the homeowners insurance coverage sold in the state. It buys more reinsurance than any other entity in the world. How much does it buy? Answer: \$2.4 billion.

If the CEA has nearly all of the residential earthquake exposure, it strains credibility to suggest an additional \$17.6 billion in reinsurance is being sold.

- 4) Even accepting RAA's false claim of \$20 billion in reinsurance capacity per region, there own claim that the reinsurance industry is 1/10<sup>th</sup> the size of the primary market clearly demonstrates this could not possibly be true.

By the RAA's measurements, the reinsurance industry is capitalized at approximately \$30 billion (1/10<sup>th</sup> of \$300+ billion). If there is \$20 billion in reinsurance being sold in all six regions of the U.S., that would mean total reinsurance cat covers would exceed \$120 billion (\$20 billion x 6). A \$30 billion industry could not possibly sell \$120 billion in coverage.

- The RAA says the industry surplus is more than \$300 billion.

This is again a highly misleading claim.

The \$300+ billion refers to *all* insurance companies, and *all* kinds of insurance, *not* companies who write homeowners coverage in disaster-prone markets. Most of the \$300+ billion surplus belongs to insurers who do not write homeowners insurance and therefore have no relevant liability for the lines of insurance covered by H.R. 21.

The ten largest homeowners insurance companies are responsible for approximately 75% of all homeowners insurance policies sold in the U.S. Their surplus is a small fraction of the \$300 billion the RAA cites.

What's more, most of that surplus is derived from non-homeowners insurance operations (e.g. auto insurance). Of the top 10 insurance companies, homeowners insurance accounts for only 10 to 15% of their total premium revenues. If the top 10 companies that write 80% of the business have a surplus of less than \$100 billion, and only 10% to 15% of that figure is derived from homeowners insurance, it is absurd to suggest that these companies would risk their overall operations for such a small part of their entire business.

- The RAA says that the California Earthquake Authority is getting a "good deal" and that rates have fallen.

In point of fact, last year the CEA collected \$394 million in premium from California consumers and paid reinsurers \$354 million for only \$2.4 billion in reinsurance coverage.

Even with the "savings" RAA touts, next year the CEA will spend \$307 million for reinsurance coverage. In other words, reinsurers take \$3 out of every \$4 dollars that the CEA collects, but only assumes \$2.4 billion out of an overall exposure that exceeds \$7.5 billion – and beyond \$7.5 billion, the CEA must prorate consumer claims.

- The Bottom Line :

If the market was healthy, there would be no availability problems.

There would be no need for a CEA or Florida Cat Fund. The Louisiana Fair Plan would not be adding 1,000 new policyholders per month. The Florida Windstorm Underwriting Authority would not have added 250,000 families (nearly a million people) last year!

#### Markets of Last Resort Growth Rates (1993- 1999)

Louisiana	+ 807 %
Florida	+ 268 %
California	+ 88 %
North Carolina	+ 69 %
South Carolina	+ 82 %

Source: PIPSO

STATEMENT of  
ROBERT W. PIKE  
EXECUTIVE VICE PRESIDENT, SECRETARY AND GENERAL COUNSEL  
ALLSTATE INSURANCE COMPANY

before the  
HOUSE COMMITTEE ON BANKING AND FINANCIAL SERVICES  
U.S. HOUSE OF REPRESENTATIVES

regarding  
H.R. 21  
THE HOMEOWNERS INSURANCE AVAILABILITY ACT OF 1999  
JULY 30, 1999

Thank you for the invitation to appear before you today to discuss H.R. 21, the Homeowners Insurance Availability Act of 1999.

Allstate insures more than 30 million homes and automobiles, making us the largest investor-owned personal lines insurance company in the United States. We share the Committee's concern about the availability of homeowners insurance and welcome the opportunity to tell you why H.R. 21 is critically important.

Twice in this decade, Allstate has faced massive losses from natural disasters. In 1992, we paid more than \$2.3 billion for claims associated with Hurricane Andrew. The loss

exceeded *all* of the premiums we collected in Florida over 50 years and consumed 42% of our nationwide surplus.

Two years later the Northridge earthquake caused industry-wide insured losses of more than \$12.5 billion. Allstate's share of these losses exceeded \$1.6 billion.

Even though we settled virtually all of our claims quickly and to our policyholder's satisfaction, our shareholders demanded that we take certain steps to assure that the company could not be threatened with insolvency from a future disaster. Therefore, we embarked on a plan to limit our exposures to catastrophes in several ways.

First, we increased the amount of private reinsurance we purchased from reinsurance companies and capital markets.

Second, we carefully limited the amount of business we did in certain areas which are susceptible to exceptionally large hurricane and earthquake losses.

Third, we participated in new state-sponsored initiatives in Florida and California designed to create new insurance capacity and improve the availability of coverage.

We are proud of the steps we have taken, but they have by no means solved the problem.

Today, Allstate buys more private reinsurance than any property insurance company in the United States. We want to buy more reinsurance, but after five years of trying, we still cannot find coverage in sufficient quantities and at prices which make it a practical means for managing our worst-case risks. It is true that the current market for reinsurance is better now than it has been for some time. We should remember, however, that over the last decade, prices and capacity have been extremely volatile.

We have tried to compensate for the lack of reinsurance capacity by limiting our own growth in certain regions, but these efforts have caused significant hardships for our agents and the communities we serve. Worse, based on our observations of the marketplace, other insurers have been unwilling or unable to absorb the business Allstate, out of economic necessity, can no longer write. From their actions, we can only deduce that other insurers have reached conclusions similar to our own: property exposures are too big; there is not enough reinsurance capacity, and writing *more* coverage without an adequate means to manage the risk is no longer a prudent business strategy.

This is the mindset that has led to the persistent problem of availability and the fraying of the homeowners insurance safety net.

Higher premiums have not eased the situation. In fact, even in markets where rates have risen dramatically, residual market pools for homeowners unable to find coverage from insurance companies have been steadily rising.

The boundaries of the North Carolina windpool have been expanded three times in less than twenty months. The Florida Windstorm Underwriting association accepted more than 250,000 applications in the last year. Louisiana adds 1,000 new families every month to its windpool. These pools would not be growing if reinsurance were available in sufficient quantities to primary insurers and at prices that allowed the risks to be properly managed.

It is our business to insure property, so we have tried everything possible to expand the industry's capacity to deal with catastrophe exposures. We have talked to investment bankers, supported tank-tank initiatives and participated in various industry coalitions. But to be quite honest, it is mostly talk. No one is prepared to put enough money on the table, at a realistic price, to make a serious dent in the reinsurance capacity gap. In fact, the capital markets are less active today than they were even three years ago.

By far, our most successful efforts have involved public-private partnerships between insurance companies, insurance regulators and state government. The Florida Catastrophe Fund (FCF), a state-run, privately financed reinsurance program is the best example. The FCF was established after Hurricane Andrew because, in the words of FCF's chief executive Jack Nicholson, "the private reinsurance market was not able to meet the needs of Florida insurers and policyholders."<sup>1</sup>

The FCF uses an innovative combination of insurance company premiums and bonding authority to create a new source of reinsurance capacity which cannot be duplicated in the private market. From the start, the motive of the program was to prepare for the next great hurricane to strike the state, and according to Deputy Insurance Commissioner Suzanne Murphy, its success is the single most important reason the entire Florida homeowners insurance market has been stabilized for the time being.<sup>2</sup>

The FCF is a significant accomplishment. It provides \$11 billion of reinsurance capacity that would otherwise not be available, and unlike private reinsurance, the growing surplus remains in Florida, to be used whenever the next hurricane hits the state. Despite this success, the Cat Fund falls considerably short of what is needed to cover a major hurricane which in Florida could cause \$40 or \$50 billion in losses.

Another modest success is the California Earthquake Authority. It was covered by the California legislature in the aftermath of the Northridge Earthquake when 96% of the private insurance market stopped writing homeowners coverage entirely. The CEA provides earthquake insurance directly to homeowners. Without it, there would be no reasonable supply of coverage available in the state,

---

<sup>1</sup> Jack Nicholson, Testimony before the House Banking Subcommittee on Housing and Community Opportunity, July 12, 1999, Tampa Florida.

<sup>2</sup> Suzanne Murphy, Testimony before the House Banking Subcommittee on Housing and Community Opportunity, July 12, 1999, Tampa, Florida.

Unlike the Florida Cat Fund, which relies on its own resources and bonding capacity for reinsurance, the CEA purchases reinsurance from private sources, including capital markets. It buys the largest layer of reinsurance sold anywhere in the world. To qualify for this honor, you would think the CEA's private reinsurance layer would be huge. In fact, the total is only \$2.4 billion, which is less than 1/5<sup>th</sup> of the loss from the Northridge Earthquake and probably less than 2% of the losses which would occur from a worst-case seismic event.

The CEA's capacity is so limited that once claims from a future earthquake exceed \$7.5 billion, even with a private reinsurance backstop, homeowners claims will no longer be fully honored. This is not an acceptable long-term solution.

The experience of Florida and California clearly show that even large states with huge insurance markets cannot adequately cover high levels of catastrophic losses. H.R. 21 will help to solve this problem. It would provide reinsurance protection from the worst 1% of natural disasters which are too large and too unpredictable to be reasonably covered by private insurers and states on their own.

The protection would be offered for sale by the Treasury Department in two ways. State programs, like the Florida Cat Fund and the California Earthquake Authority, could purchase coverage directly from the Treasury at actuarial rates. In addition, the Treasury would offer reinsurance contracts to the highest bidders in regional insurance auctions intended for insurance companies and reinsurers.

It is the intent of the program to encourage the development of other, more innovative risk financing mechanisms in the private sector. But it recognizes that those new mechanisms are in their infancy and unlikely to generate significant new capacity for at least a decade.

The federal reinsurance plan envisioned by H.R. 21 is not activated until insured losses from a natural catastrophe exceed a threshold defined as a 1-in-100 year event. This means that the vast bulk of insurance losses will continue to be covered exclusively by the private market. Once losses exceed the 100-year threshold, federal reinsurance pays 50% of eligible losses, up to a predetermined maximum. In the case of the Florida Cat Fund, for example, federal reinsurance would only cover insured losses after \$21 billion in losses had been absorbed by insurers and the state program.

Opponents of H.R. 21 have sought to portray the triggers in H.R. 21 as unnecessarily generous. They claim that the program will cover events which cause damage as low as \$2 billion. In fact, the bill says that the trigger should be a 1-in-100 year event for a state or region, or \$2 billion, whichever is *greater*. Under this standard, the trigger for Florida, as I have already mentioned, is \$21 billion *not* \$2 billion. Earthquakes in the New Madrid region of Missouri, Arkansas, Tennessee, Illinois and Indiana would only be covered after losses exceeded \$10 billion. In the Pacific Northwest, the trigger would be in the \$6 billion range. By using the 1-in-100 year criteria as the standard for each and every region, H.R. 21 assures that *all* states will be treated fairly and equally.

In closing, Mr. Chairman, let me say that Congress has a clear opportunity to address a problem while it is a trend instead of a crisis.

We know that the mechanisms in place are inadequate for the problem. Insurance markets are deteriorating, and they are doing so most quickly in the areas which are likely to suffer natural disasters of extremely large magnitude.

A federal reinsurance program will bring stability and predictability to insurance markets. It will assure the integrity of state programs which are certain to fail if a large event occurs. It is not a replacement for the private markets. Insurance companies, and insurers in cooperation with state government, will continue to cover 99 out of 100 risks



with no federal backstop. This means that insurers will still require as much private reinsurance as is available. But there are some events which logic tells us are too big for any insurance company or any state to manage, and it is unrealistic to think that these events should be our responsibility alone.

Whether Congress takes action on H.R. 21 will do nothing to change the odds of a catastrophic event occurring. However, Congress can influence whether the recovery is swift and orderly or delayed and haphazard. Assuring the integrity of the private insurance system is the fairest, most equitable and cost-effective way for government to support the rebuilding process. It is certainly better than the ad hoc relief and government handouts that characterize our current approach to dealing with natural disasters.

We urge the Banking Committee, as it did last year, to report the language contained in H.R. 21 and move it swiftly to the House floor.

## SUMMARY OF THE TESTIMONY OF DARRYL D. HANSEN REGARDING H.R.21

Darryl D. Hansen is the Chairman, President and CEO of GuideOne Insurance, a medium-sized insurer that writes commercial and consumer insurance across the country. The consumer business includes homeowners' insurance, some of which is written in areas prone to catastrophe losses. Mr. Hansen supports H.R. 21 as a high-level federal reinsurance safety net to supplement the private insurance and reinsurance markets in the event of a truly major catastrophe loss that could have a national economic impact.

Adequate, affordable catastrophe reinsurance is an essential part of prudent financial planning for small to medium size insurers which write homeowners' insurance in geographic areas that are or may be vulnerable to catastrophic losses, such as hurricanes, earthquakes, and other natural disasters. Without reinsurance, such companies cannot write insurance in these geographic areas.

A lack of available, affordable catastrophe reinsurance also affects consumers. If the smaller insurers cannot write the business, competition will suffer. Catastrophe losses often result in higher premiums and a lack of availability of consumer insurance. Insurance that is available may be restricted as to deductibles and coverages. In the absence of adequate reinsurance, insurance companies have no choice but to take reasonable and necessary steps to protect their own solvency, which in turn impacts consumer insurance markets.

Major catastrophe losses will also have a significant affect upon the national economy. This includes the direct impact caused by the catastrophe – deaths, injuries, property damage, disruption of the local economy, unemployment for workers in destroyed businesses, and the ripple effect as suppliers or vendors to other manufacturing plants or businesses cannot fulfill their contracts. Another direct impact would be the depressing effect upon national financial markets caused by the liquidation of insurer investments to generate cash to pay claims, and the likelihood of upward pressure on interest rates as multiple parties pursue the same money supply. This impact could be felt by people and companies all across the country, even though there was no direct connection with the actual physical loss caused by the catastrophe.

H.R. 21 contains a solution that could serve to avoid the worst-case potential of a truly major catastrophe by providing a high level federal reinsurance safety net that would not compete with existing private markets, and would only be triggered by such a major event. This solution is aimed at preventing a negative national economic impact resulting from such an event.

July 30, 1999

**WRITTEN PRESENTATION TO THE HOUSE COMMITTEE ON  
BANKING AND FINANCIAL SERVICES  
DARRYL D. HANSEN, PRESIDENT, CHAIRMAN AND CEO  
GUIDEONE INSURANCE  
JULY 30, 1999**

Good morning. My name is Darryl Hansen. I am Chairman, President and CEO of GuideOne Insurance, from West Des Moines, Iowa. I am here today to offer some comments on H.R. 21, the "Homeowners Insurance Availability Act of 1999", from the perspective of the small-to-medium size insurance company. I also serve on the board of directors of the National Association of Independent Insurers, which is an association of more than 600 insurers doing business across the country. Many of these companies fall into the small-to-medium size category as well, so my comments may apply to the interests of the NAII and its members.

GuideOne Insurance has been in business since 1947. It is located in Iowa and does business all across the country. GuideOne originally sold automobile insurance to nondrinkers, but over the years has expanded its product lines to include homeowners insurance and houses of worship. At the present time, GuideOne sells homeowners insurance to tens of thousands of people in twenty-seven states. GuideOne is also one of the leading insurers of houses of worship, with approximately 40,000 policies in force in the United States.

I wish to express support for H.R. 21 and its proposal to create a reinsurance safety net to supplement the private insurance and reinsurance markets in the rare event of a truly major, widespread catastrophe loss. This federal-level safety net need not compete with the private sector; nor should it be seen as simply benefiting a few states or insurance companies. Instead, I urge the committee to recognize that certain types of loss events may result in impacts on consumers far beyond the specific geographic area in which it occurs, and could also cause economic disruption beyond the insurance industry, as my following comments will indicate. These losses and costs could be both direct and indirect.

Although GuideOne is an Iowa company, the subject of catastrophe loss exposures, known as "cats", is of vital importance to the company. Very few companies have the financial resources to withstand large cat losses without adequate reinsurance. Normal claims reserves, which are sufficient on a day-to-day basis to handle customer losses, can be exhausted when a cat occurs. In that event, the resources provided by reinsurance are critical to providing benefits to customers while preserving the viability of the company.

However, GuideOne has several issues of concern that I would like to share with you today. First, and a source of a very direct impact on the company, GuideOne writes insurance in areas that are prone to cat losses. In the last decade, our insureds have sustained losses in Oklahoma from tornadoes, in Texas from hail storms, in California from earthquakes, and in Florida and other coastal areas from hurricanes.

Second, and beyond GuideOne's own interest, cat losses have a potential to cause serious financial consequences to small-to-medium size companies, regardless of the precautions they may take. There are 57 domestic property/casualty insurers in Iowa, and the insurance industry employs 40,000 people. This is clearly an industry of particular importance to the state, and any event which resulted in a serious, negative impact to the financial stability of one or more companies in that industry would affect greatly the State of Iowa and its citizens, regardless of where the event occurred.

Third, smaller companies may bear greater consequences than larger companies do when cats occur. In fact, in the aftermath of Hurricane Andrew in 1992, ten insurance companies, most of them in the smaller size category, were declared insolvent. Due to GuideOne's size, we must be constantly mindful of the company's cat exposure. Finally, over the years cat exposures have impacted where the company has chosen to do business. In the coastal areas of several states, GuideOne is extremely selective as to where, and to what extent, it will accept property risks.

Cat losses and the precautions necessary for companies to take in the face of cat exposures, have a number of specific, tangible impacts. Insurers must purchase cat reinsurance. If a company sustains high reinsurance losses in one year, that company's reinsurance premiums may increase in future years. Reinsurance losses may also impact reinsurance coverage.

In fact, due to GuideOne's losses in the Oklahoma tornadoes earlier this year, the company had to purchase additional coverage, at an additional premium. Although we were able to do so, in a truly major catastrophe situation, there could be hundreds of insurers seeking to do this at the same time. In that event, such coverage might not be available from the standard reinsurance market, which means companies could be forced to continue business operations with inadequate reinsurance.

Finally, as noted above, ten companies became insolvent in the wake of Hurricane Andrew. These were smaller companies. The hurricane losses were such that claims reserves were exhausted, reinsurance limits were exceeded, and the companies' surplus as regards policyholders was also impaired. Although state guarantee funds can step in and provide some funding in such circumstances, the usual result is that claims are paid subject to a cap in the guarantee fund statutes, outstanding policies are cancelled, even if they had no claims, and premium refunds might be inadequate.

Think of losing your policies even if you had no claims, being forced to find other coverage on very short notice, without receiving a premium refund – and then magnify that imagined experience by the thousands of insureds actually involved. The insolvency of even a small company involves great dislocation to many people – insureds, claimants, employees, agents – and imposes a cost on the insurance marketplace that can last for years into the

future, as guarantee fund costs are assessed against insurers, to find their way ultimately into consumer premium costs.

More specifically, cat losses and the costs associated with providing for cat exposures have a definite impact upon individual consumers. As noted above, there is an adverse impact upon premiums. There is also the prospect of an availability problem. In the aftermath of Hurricane Andrew, a number of insurers withdrew from the Florida consumer market or severely restricted the amount of new business they would accept. A similar result happened in California after the Northridge earthquake of several years ago. If faced with the prospect of crippling losses, insurance company executives have an obligation to take prudent measures to protect their company. If this means withdrawing from a cat risk area, then the executives must do so.

There may also be underwriting differences based upon the degree of catastrophe risk exposure. For example, agents may have their binding authority restricted or removed. Underwriting rules and guidelines may be stricter in areas subject to high wind exposures than in more protected areas. Deductibles may be offered as a percentage of value, rather than the more familiar stated dollar amount. There may be differences in the pricing structure, resulting in higher premiums for similar structures located in cat-prone areas relative to non-cat areas.

These differences may be actuarially justified, based upon sound statistical evidence, and completely legal. Nonetheless, in the event of a major catastrophe, homeowners' insurance may not be available or affordable. And, with regard to insurance companies, reinsurance may become less available or affordable, which then places insurance companies in a position similar to individual insurance consumers. This is not a qualitative difference as much as a quantitative one. A welcome solution to the problem is offered by H.R. 21.

Beyond the impact upon individual companies or consumers, a major cat has the potential to affect competition within the property/casualty insurance market as a whole. The insurance business is a highly competitive business. For example, in addition to the 57 domestic Iowa companies noted above, another 800 property/casualty insurance companies are admitted to do business in Iowa. This is obviously an enormously competitive business, even though most companies are small and compete only in one state or regionally. On the other hand, there are a handful of companies that have the potential to dominate the insurance market. The largest United States company, State Farm, insures approximately one out of every four homes in the country.

As is readily apparent, State Farm can leverage its business in geographic areas with little or no cat exposures and spread the risk for those states with greater cat risks. Small companies that do business in only one or a handful of states have no such advantage. Accordingly, reinsurance is a more critical component of prudent business and financial planning for these small companies. In the event of a major catastrophe, if reinsurance

became less available or affordable, smaller companies could be more severely impacted. The potential end result is to drive smaller companies to merge or go out of business, thus reducing competition.

This is not to suggest that size, growth or success are improper or inappropriate in any fashion. Instead, this merely underscores the importance of the reinsurance role, its significant impact upon smaller companies, and the potential for a negative result on the competitive insurance marketplace.

I have addressed the impact of cat losses and reinsurance on individual consumers, individual insurance companies, and the competitiveness of the insurance industry as a whole. There is also the potential for a larger economic impact in the event of a major catastrophe. This would affect people and companies beyond the actual cat areas and its immediate victims. Insurers maintain sufficient liquidity to handle the needs of their customers on an ongoing basis. Assets are invested in the financial markets in vehicles that approximate the long- and short-term needs of the company, and which appropriately match and balance those needs. In the event of a major cat loss, those ordinary and predictable liquidity needs may be quickly exceeded. In that event, other financial market investments will need to be liquidated in order to meet the customer needs for ready cash.

Although a planned disposition of investments would be the preferable route, during the response to major cat losses companies and state insurance regulators may not have the luxury of waiting for supply and demand to maximize portfolio value. When one company has to generate cash quickly, it may not be noticed by the financial markets. When dozens of companies do, it may have an immediate depressing effect upon values and the financial markets. This impact will not be restricted to insurance companies or other large, institutional investors. Investment value declines will affect the ordinary citizen with assets invested in money market and retirement plans as well. In our own recent experience, such as October, 1987, we can well see what happens when people respond to perceived or actual declines in financial market values. In addition, since most insurers are heavily invested in fixed income securities, sales of those types of assets would create upward pressure on interest rates, which would then be felt by all consumers and commercial borrowers.

And, this scenario does not even contemplate the ripple effects in the economy as home offices, factories and manufacturing plants, suppliers, and other vendors begin to shut down, whether as a result of direct damage or loss of business from locations that sustain direct damage. The recovery to the 1987 financial markets disruption was not particularly difficult. However, if one contemplates massive physical destruction and the relocation of hundreds of thousands, if not millions, of people for an extended period of time, consider for a moment how much more challenging that recovery would have been.

In short, a truly major catastrophe loss scenario could result in country-wide effects, whether directly caused by damage or indirectly caused by financial market or ordinary

commerce interruptions. Consideration of such a scenario should also emphasize the importance that reinsurance plays in cat loss planning for insurance companies, particularly those of small to medium size. I believe that H.R. 21 can play a role in blunting or minimizing the worst potentials caused by cat losses. By providing a high-level safety net, in conjunction with prudent and conservative insurer loss reserves and the existing private reinsurance market, H.R. 21 would provide assistance in the event of a major catastrophe in maintaining security in financial markets, competition within the property/casualty insurance industry, individual company solvency, and ultimately, consumer protection. This is not an insurance industry problem – it is a national economic issue with far-reaching ramifications. I urge the Committee to give serious consideration to the solution contained in H.R. 21.

**HEARING ON H.R. 21  
HOMEOWNERS' INSURANCE AVAILABILITY ACT**

**STATEMENT OF TOM MILLER  
DIRECTOR OF ECONOMIC POLICY STUDIES  
COMPETITIVE ENTERPRISE INSTITUTE**

**BEFORE THE  
COMMITTEE ON BANKING AND FINANCIAL SERVICES  
UNITED STATES HOUSE OF REPRESENTATIVES**

**JULY 30, 1999**



## INTRODUCTION

Mr. Chairman, my name is Tom Miller. I am director of Economic Policy Studies at the Competitive Enterprise Institute (CEI). CEI is a non-profit public policy organization dedicated to the principles of free enterprise and limited government. CEI works to educate and inform policy makers, journalists, and other opinion leaders on market-based alternatives to political programs and regulations. In keeping with the "Truth-in-Testimony" rule, I note that the Competitive Enterprise Institute does not receive any money at all from the federal government, nor has it in the past.

Thank you for the opportunity to discuss the Homeowners' Insurance Availability Act of 1999, the availability and affordability of homeowners' insurance in disaster-prone areas, and the possible effects of a federal reinsurance program.

Since 1995, the Competitive Enterprise Institute's Insurance Reform Project has urged market-based reform of insurance coverage for catastrophic risks. We have carefully examined the evolving proposals in Congress to enact a federal reinsurance program aimed at assisting those markets most at risk from natural disasters. Although the Homeowners' Insurance Availability Act of 1999 represents an improvement over previous versions of such programs, it still contains several serious shortcomings and fails to present the best answers to the challenge of dealing with natural disaster risks.

The bill still has the potential to undermine private insurance markets and crowd out the development of better alternatives. It remains likely to produce cross-subsidies from low-risk insurance policyholders to high-risk ones, distort incentives for loss control

and loss mitigation, further subsidize development in catastrophe-prone areas, increase unnecessary federal intervention in state regulation of insurance, and impose significant financial risk on taxpayers throughout the country.

## **FIX PUBLIC POLICIES FIRST**

As the Shadow Insurance Regulation Committee (sponsored by the Competitive Enterprise Institute) recently noted, "The ability of private insurance and financial markets to promote better management of catastrophic risk has been impeded by regulation and government policies. There is a strong need to align private incentives and public policies to control catastrophic losses and distribute their burden efficiently."

After Hurricane Andrew and the Northridge earthquake delivered a pair of shocks to the private insurance industry earlier this decade, insurers reassessed their exposure to catastrophes. They sought to raise their rates and lower their catastrophe exposure to safer levels. Innovative financial instruments were developed to securitize catastrophe risk and tap financial markets to provide additional capacity. The capacity of the private insurance industry, as well as the availability of reinsurance, has grown.

Nevertheless, state government officials have restricted necessary market adjustments in order to moderate the negative effects on property owners in high-risk areas. This, in turn, has discouraged the inflow of the additional capital needed to cover potential catastrophe losses and exposed many insurers and the public to excessive financial risk. Constraints on insurers' efforts to charge adequate rates decrease the voluntary supply of catastrophe insurance and hamper insurers' ability to purchase

reinsurance and other financial instruments to diversify their catastrophe risk. Regulatory restrictions on rates and underwriting have discouraged the entry of new insurers into the market that could safely assume more catastrophe exposure and enhance the availability of coverage. Suppression of residual market rates and the assessment of the resulting deficits on voluntary market policies served to diminish further the voluntary supply of insurance. Restrictions on rates and underwriting also reduced private incentives to mitigate catastrophe hazards.

Federal government tax and expenditure policies also subsidize excessive risk taking by property owners. Federal post-disaster assistance has discouraged the purchase of insurance and investments in hazard mitigation. Current accounting rules and federal tax law do not allow insurers to set aside reserves for catastrophe losses that have not yet occurred.

#### **LOW PRICES + LOW TRIGGERS = HIGH TAXPAYER COSTS**

Private insurance and financial markets can effectively manage catastrophic risk if supported by sound government policies. Unfortunately, the Homeowners' Insurance Availability Act fails to meet this challenge. In brief, the bill's pricing provisions threaten to increase cross-subsidies and distort private insurance markets. The triggers that set a threshold for retained losses are still too low. The proposed legislation exposes federal taxpayers to greater financial risk. It fails to provide proper incentives to expand the supply of private insurance against catastrophic risks.

The full effects of the provisions in H.R. 21 for pricing federally backed reinsurance contracts remain uncertain, in part because the Secretary of the Treasury would retain a considerable amount of discretion in setting those prices and implementing the reinsurance program. Last year, the Congressional Budget Office observed that such discretion makes it not possible to determine what form the reinsurance contracts would take, how many of such contracts would be sold, the level of losses at which the contracts sold to state programs would be triggered, or the risk loads that would be included in the prices of the contracts. The Competitive Enterprise Institute shares CBO's skepticism and doubts that the federal government would perform better than the insurance industry in overcoming the problems of estimating catastrophic losses and properly pricing insurance contracts.

Indeed, the underlying purpose of the legislation is, to some degree, to transfer risk from policyholders in disaster-prone areas to the Treasury and thus to taxpayers in other parts of the country. Although the establishment of regional auctions for sale of some of those reinsurance contracts represents a move in a more market-oriented direction, the risk of creating inefficient cross-subsidies between different areas is only reduced in part. Given likely political pressure by particular states and other interests to keep the reinsurance contract prices low so that insurance coverage would be affordable in high-risk areas, it remains much more likely that the federal reinsurance contracts would be priced too low rather than too high.

The asymmetrical effects of pricing mistakes for such reinsurance contracts also are likely to increase potential taxpayer liabilities. As CBO noted last year, setting prices too low would encourage the sale of large numbers of reinsurance contracts and create a

large contingent liability, whereas setting prices too high would hinder sales and possibly yield few if any gains to Treasury. Moreover, miscalculations that set reinsurance contracts too low are unlikely to be corrected quickly, because the accuracy of the prices for contracts covering long-tailed, catastrophic risks will be revealed only over a longer period of time.

The coverage triggers under H.R. 21 remain relatively low compared to current private sector insurance capacity. Whether those triggers are set at \$ 2 billion, the costs of a one-in-100-year event, the claims-paying capacity of a particular state program or industry region, or some interim variation, the level of such attachment points for federal coverage under the bill would impede the development of private market insurance coverage.

Private industry has already handled much more costly events. According to the Insurance Information Institute, the 1994 Northridge Earthquake cost \$ 12.5 billion, while Hurricane Andrew in 1992 had a price tag of \$ 15.5 billion. Since those disasters, the capacity of the private insurance industry has grown significantly, and reinsurance availability has increased remarkably. The U.S. property/casualty insurance industry has surplus of more than \$ 300 billion. Some very recent, but preliminary, research at the University of Pennsylvania's Wharton School suggests that industry capacity to handle catastrophes of moderate size is more than adequate. Additional research findings still under review at Wharton remain controversial, because they set highly theoretical, very optimistic upper bounds on industry capacity and suggest that private industry could pay for a large portion of catastrophes as great as \$ 100 billion. What is most important at this stage is not how many tens of billions of dollars the preliminary Wharton numbers

may turn out to be above more realistic benchmarks. The ultimate Wharton findings still should reveal that, although gaps in industry capacity provide a necessary role for further development of innovative financial instruments and contracts to handle catastrophic losses, those shortfalls in private sector financing do not yet justify a new federal reinsurance program.

It remains clear that industry capacity and efficiency to handle catastrophic risks continues to improve. Rates for catastrophe reinsurance continue to fall and the supply of reinsurance is plentiful. Earlier this year, special insurance panels in New York and Louisiana that studied property insurance coverage and catastrophic risks concluded that private insurance capacity was growing and that establishing a new catastrophic reinsurance fund in those states was not necessary, given current market conditions and trends.

As Catherine England and Jeffrey Yessierli noted in CEI's 1998 study, *Assuring Against Natural Disasters: Privatizing the Market-Based Response*:

There are two important lessons to be learned from the story of the reinsurance industry's unexpectedly quick rebound in terms of overall capacity. First, the insurance market is dynamic. Supply shortages do not last for long if insurers and potential insurers can change premiums commensurate with the risk they are assuming. Consequently, policyholders interested in helping to reduce insurance shortfalls in the wake of future disasters should be creating a legal and regulatory environment that is conducive to growth in insurance industry capacity.

However, instead of encouraging greater private financing and market-based approaches to the funding of catastrophic risks, R.R. II would create more

intervention by federal and state governments in private insurance markets. The lure of potential federal reinsurance subsidies would foster the growth of state reinsurance funds and residual market pools, as well as the creation of new ones. As Professor Scott Harrington of the University of South Carolina notes in a forthcoming CEI study (*Taxes and the High Cost of Catastrophe Insurance*)

A large degree of regulatory control on rates and the supply of coverage (e.g., cancellations and renewals) accompanies those mechanisms. Although adopted during severe market disruptions, over time these mechanisms tend to crowd out viable private sector coverage, in part due to their favorable tax status. Price and supply controls tend to produce cross-subsidies from low-risk to high-risk policyholders within the state, which in turn inefficiently distorts incentives for loss control and loss mitigation. The threat of rate inadequacy and government restrictions on insurers' ability to control their exposure increases risk for insurers. This regulatory risk undermines the goal of expanding the supply of private coverage. Moreover, policyholders are exposed to risk of assessments or higher taxes to pay for large unfunded losses.

Section two of the Homeowners' Insurance Availability Act promises that its proposed federal reinsurance program will be "temporary," any such program must be founded on actuarial principles, and it will be priced in a manner that minimizes the potential impact on the Treasury. However, it is more likely that, once enacted, the federal reinsurance program would live on indefinitely like most federal programs -- despite the sunset dates provided in the bill. The combination of regulatory discretion and political pressures in future years make adherence to actuarial principles and market-based pricing unlikely, thereby increasing potential unfunded liabilities that will be transferred to federal taxpayers through the Disaster Reinsurance Fund's \$ 25 billion annual line of credit.

As the Congressional Budget Office noted last year, this type of federal reinsurance program would not necessarily reduce significantly other federal payments for disaster assistance. Most federal disaster relief assistance covers other types of losses (catastrophic crop insurance, disaster relief grants for public infrastructure assistance to state and local government) that would not be covered by the proposed federal reinsurance contracts. Even savings to the federal government from mitigation efforts remain "speculative."

To the extent that federal reinsurance coverage distorted market prices by subsidizing insurance in high-risk areas, it would encourage families to remain in or move to those areas instead of moving to or remaining in low-risk areas. Potential harm to individuals' health and safety, as well as questionable development in environmentally fragile areas, would increase.

The Homeowners' Insurance Availability Act also would increase the role of the federal government in regulation of insurance. The Secretary of the Treasury would certify eligible state reinsurance programs; set the prices, terms, and conditions of reinsurance contracts; determine claims-paying capacity for various state programs and industry regions; and solicit loss exposure data. Advocates of decentralized and more flexible state regulation of insurance would be disappointed to find an expanding array of federal insurance edicts and political demands for greater federal micromanagement of insurance markets in future years.



## PRIVATE INSURANCE VS. GOVERNMENT INSURANCE

Although H.R. 21 attempts to mimic some aspects of market-based insurance, its proposed federal reinsurance contracts retain at their core the key structural components and characteristics of all government-provided insurance. As Yale Law School professor George Priest noted in a 1995 article (*The Government as an Insurer in the Context of Catastrophic Loss*), the government, by definition, must be inclusive in the insurance coverage it offers. When this "compulsion of inclusiveness" is applied to catastrophic coverage, it diminishes the ability of the government to reduce risks through aggregation. After all, catastrophes involve a highly correlated incidence of loss among the population. But Priest concludes, "Providing coverage of highly correlated losses is exactly the opposite of the risk reducing function of aggregation."

Even if H.R. 21 worked as perfectly in practice as its proponents contend (diversifying risk through regional auctions, remaining sensitive to private market capacity, and resisting pressures for below-market pricing), it would remain subject to the inherent characteristics of government-managed insurance coverage identified by Professor Priest. Government provision of insurance (even with \$ 2 billion thresholds and 50-percent cost sharing) systematically redistributes wealth toward relatively risky activities. Private insurance, through premiums, "taxes" the most risky activities of society -- and thereby reduces the risk level -- and then invests those premiums in the most productive activities in society, and reduces the effective cost of those risks even further. In comparison, government insurance taxes the most productive activities to distribute to the most risky. Priest concludes that the commitment of either state or

federal governments to non-discrimination (in the risk-based, economic sense) prevents control of adverse selection through risk segregation, and government responsiveness to voter interests cripples efforts to control moral hazard.

The case for government-based management of insurable risk is quite weak. Where the federal government can "succeed" is in redistributing income under an insurance guise to activities that could not support an insurance market. The ability of the Homeowners' Insurance Availability Act to escape the inherent flaws of government-managed insurance remains unproven.

#### ADDRESS UNDERLYING PROBLEMS

The current federal reinsurance proposal fails to address the underlying regulatory and tax policies that have limited the availability of insurance coverage that can be offered to consumers and underwritten by private insurers of catastrophic risks. As the Shadow Insurance Regulation Committee concluded last March:

Constraints on insurers' efforts to charge adequate rates decrease the voluntary supply of catastrophe insurance and hamper insurers' ability to purchase reinsurance and other financial instruments to diversify their catastrophe risk. Restrictions on rates and underwriting also discourage the entry of new insurers into the market that could safely assume more catastrophe exposure and enhance the availability of coverage. Suppression of residual market rates and the assessment of the resulting deficits on voluntary market policies serve to further diminish the voluntary supply of insurance.

In 1995, the Academic Task Force on Hurricane Catastrophe Insurance, a group established by the state of Florida to review the state's property insurance market, identified more flexible rates and more flexible insurance products as two of the keys to

reviving Florida's collapsing homeowners insurance market. A private market for disaster insurance will not function properly if insurance companies are not allowed to charge premiums commensurate with the considerable risk of underwriting such insurance.

To attract new insurers to disaster-prone states, and to encourage existing companies to increase the supply of insurance provided, open competition rate setting systems should be established. Individual insurance companies should be allowed to determine for themselves what are adequate premiums. As more insurers are attracted to the market for disaster insurance, increased competition among providers will help assure that the premiums charged reflect expected claims costs. In the words of the Academic Task Force, "Eventually greater diversification of geographic risk and larger numbers of financially healthy insurance companies in Florida will increase competition and decrease rates."

Higher disaster insurance rates may mean that some people will decide they cannot afford to live in areas threatened by hurricanes or earthquakes. But one of the roles of insurance is to help identify those activities that embody higher risks and to force policyholders to internalize the costs associated with their decisions. At present, taxpayers around the country are subsidizing individuals who choose to live in these areas whenever the federal government steps forward to provide disaster relief. It is not unreasonable to expect individuals who live in these locales to internalize more of the costs of their decisions through higher premiums.

These higher premiums can be mitigated in part by allowing insurance companies more flexibility in writing a wider variety of homeowners policies. Giving homeowners a

choice of deductibles or coinsurance levels would be one mechanism for giving homeowners some control over their insurance costs. Different size deductibles and coinsurance also have been used to give property owners added incentives to undertake measures that will help reduce their losses in the event of a disaster. As George Priest has pointed out, deductibles and coinsurance have an advantage over specific mitigation requirements because they leave property owners free to undertake higher levels of mitigation and to develop and make use of new (possibly better) methods for protecting their property in the event of a disaster.

### **COSTLY TAX RULES**

In addition to the above regulatory policy impediments to greater availability of private catastrophic insurance coverage, current federal tax rules make insurance against relatively rare but very large catastrophe losses much more expensive. In his forthcoming CEI study that outlines the case for tax-sheltered catastrophe reserves, Professor Harrington first observes that post-catastrophe disruptions in the supply of private insurance are inherently temporary, absent regulatory restrictions on catastrophe insurance rate changes, limitations on non-renewals, and the adoption or expansion of state-mandated catastrophe insurance mechanisms. However, he concludes that the high long-run cost of providing catastrophe coverage and limits on the capacity of catastrophe reinsurance present more chronic problems. A key factor that increases the cost of catastrophe coverage (and remains unaddressed by H.R. 21) is federal income tax law.

U.S. insurers are not allowed to establish tax-sheltered reserves for catastrophe losses; they can only deduct catastrophe losses that have occurred. As a result, insurers must pay high corporate taxes on underwriting income in years of little or no catastrophe loss. In addition, insurers are subject to corporate income tax on investment returns on the large amounts of capital needed to provide catastrophe coverage.

Harrington finds that for a given-sized catastrophe, there is a strong inverse relationship between the premium needed and the probability that the loss occurs. The combined effects of taxes on premiums and investment income produce very large premiums in relation to expected indemnity for small probability events. The key result is that the tax code produces large prices for catastrophe coverage; i.e., for coverage of large losses that occur with small probability.

Harrington concludes that a well-designed system of tax-sheltered reserves for catastrophe coverage will materially improve the affordability and availability of catastrophe insurance in the private sector with minimal administrative and compliance costs. The possible negative budgetary effects will be modest in the short run and could even be favorable over time. Rather than crowding out private sector coverage, such a system will increase supply, lower prices, and otherwise mitigate the adverse consequences of current tax rules on catastrophe insurance markets.

Finally, Harrington outlines six specific benefits of tax-sheltered reserves:

1. Greater private sector capital and supply, lower prices, and lower insolvency risk.
2. Less economic hardship following large catastrophes and less reliance on disaster assistance.

3. Fewer and less severe short-run disruptions in insurance markets following catastrophe losses.
4. Less pressure for the creation of inefficient state mechanisms to hold down the cost of coverage on a tax-sheltered basis and for creation of a potentially costly federal reinsurance mechanism.
5. Greater scope of private sector coverage with market-determined rates will improve incentives for loss control and mitigation.
6. Incentives to shift risk abroad through reinsurance and use capital market instruments will depend more on the ability to spread risk efficiently and less on tax considerations.

Thus, rather than increase the risks of further distorting private insurance markets and increasing potential taxpayer liabilities by enacting a poorly designed federal reinsurance program, one should consider a better starting point for policy reform that bolsters the capacity of private insurers to handle increased levels of catastrophic risk. Fixing current tax law to encourage insurers to set aside and accumulate special reserve funds devoted exclusively to covering future catastrophic losses would represent a more prudent, market-based approach.

Private insurers should no longer be discouraged from accumulating after-tax retained earnings to protect their policyholders against low-probability, high-cost catastrophes at some future date. Under current law, mutual insurers face strong pressure to use more of their "surplus" (total capital remaining after claims costs and operating expenses are paid) to pay tax-deductible dividends to policyholders each year. Insurers

organized as corporations also may prefer to pay higher dividends to their stockholders than risk takeover bids attracted by "spare cash" that cannot be held in a separate reserve account.

Correcting those flaws in the tax code and current accounting rules would provide incentives, not penalties, for insurers to increase their capability to manage catastrophic loss exposures. Most other major industrialized countries already allow or require insurers to reserve for future catastrophe losses, on a tax-deductible basis. Even several state government-run catastrophe funds in the U.S. have received similar favorable federal tax treatment. Correcting the current flaw in the U.S. tax code for private insurers' catastrophe reserves will put more insurance premium payments to work where they most efficiently protect policyholders. Encouraging growth of substantial pre-funded insurer reserves will establish a necessary "buffer" against insurer insolvencies, keep natural disaster claims handling in efficient private markets, and help maintain the link between risk taking and personal responsibility through risk-based insurance pricing.

## **NEW FINANCIAL INSTRUMENTS**

The private sector also is developing new securities to transfer catastrophic risks. These new financial instruments (catastrophe options, catastrophe swaps, catastrophe bonds, contingent surplus notes, and other new derivatives products) are all devices used for transferring or capitalizing the risk associated with natural disasters. These securitized products take advantage of the fact that catastrophe losses exhibit little correlation with capital market indices, as well as the depth of funding available in U.S.

capital markets. Although these products are fairly new, they represent promising new market approaches to obtaining the capital needed to fund catastrophic risks. Regulators should allow and even encourage insurers to develop and use these financial instruments. However, the speed of financial innovation has been slowed down by the commitment of many large private insurers to state-run catastrophe funds, according to Professor Dwight Jaffee of the University of California at Berkeley and Professor Thomas Russell at Santa Clara University (*Financial Markets and Financial Intermediaries: The Case of Catastrophe Insurance*).

## CONCLUSION

In its March 1 statement on "The Efficient Management of Catastrophic Risk," the Shadow Insurance Regulation Committee recommended that policymakers should consider a coordinated set of measures that allow and encourage optimal private choices with respect to the provision and purchase of catastrophic insurance and investments in hazard mitigation. Those measures included:

1. Limit government disaster assistance to short-term emergency aid and eliminate government subsidies for rebuilding damaged structures.
2. Focus federal efforts on pre-disaster planning and mitigation with means-tested financial assistance to low-income homeowners if necessary.
3. Continue development of legislation that would enable insurers to establish tax-deferred catastrophe reserves as other countries allow.



4. Restructure state catastrophic risk financing mechanisms to be financially sound and encourage private assumption of risk where possible. Any federal reinsurance program must not compete with private reinsurance and financial markets, and it should gradually erode as private markets fill any residual "capacity gap." The attachment points for any such program should be set sufficiently high to avoid competing with catastrophic coverage available from the private sector.
5. Ease state regulatory restrictions on policy provisions, pricing, underwriting, and risk diversification and provide temporary mechanisms to assist the transition for consumers that are negatively affected by market adjustments.
6. Consider imposing earthquake insurance requirements for home mortgages protected by federal financial guarantees.

The Competitive Enterprise Institute's own research concludes that the most direct and straightforward way to correct problems in the current insurance market would be to remove the impediments of current public policies that reduce the potential supply of, and the demand for, catastrophic coverage. By obfuscating the true costs of insuring property in disaster-prone regions and impeding the ability of insurers to raise the capital required to meet such liabilities, government policymakers have contributed significantly to creating current distortions and problems.

Public policy should attempt to limit cross-subsidies from taxpayers in safer regions to residents of disaster-prone areas. Further, federal policy should not reward

those who simply assume that they will be bailed out in the event of a catastrophe. While it is easy to sympathize with homeowners in disaster-prone areas in their desire for lower rates, rates that are made artificially low through government action come at a high cost to taxpayers in the rest of the country if and when the federal government must step in to assume the cost of disaster-related losses.

But if insurers are given the freedom to structure coverage more flexibly, rate risks appropriately, charge premiums that reflect that risk, and raise and build the capital funds required to pay for the substantial liabilities of disaster insurance, insuring catastrophic events becomes a more manageable task. It is in the interest of consumers and insurers alike that insurance markets be made more stable and the supply of insurance remain as consistent as possible. Freeing up the private market will, in the long run, prove to be more productive than creating yet another partly disguised federal subsidy program.



**STATEMENT OF  
THE NATIONAL ASSOCIATION OF REALTORS®  
BEFORE THE HOUSE BANKING AND FINANCIAL  
SERVICES COMMITTEE  
ON  
H.R. 21, THE HOMEOWNERS' INSURANCE AVAILABILITY  
ACT  
JULY 30, 1999**

**STATEMENT OF**  
**THE NATIONAL ASSOCIATION OF REALTORS®**  
**BEFORE THE**  
**HOUSE BANKING**  
**AND FINANCIAL SERVICES COMMITTEE**  
**ON**  
**H.R. 21, THE HOMEOWNERS' INSURANCE**  
**AVAILABILITY ACT**

**July 30, 1999**

Thank you for the opportunity to present the views of the NATIONAL ASSOCIATION OF REALTORS® on H.R. 21, the Homeowners' Insurance Availability Act. I wish to thank Chairman Leach and Chairman Lazio for their leadership in building bi-partisan support on this very important issue.

My name is Barbara Connery. I am a REALTOR® from North Carolina and a Director of the North Carolina Association of REALTORS®.

The deterioration in the availability and affordability of homeowners' insurance in disaster-prone areas is an issue of very real concern to NAR. Our members specialize primarily in the business of assisting sellers and buyers in residential sales transactions. It is this business focus that motivates NAR's interest in the resolution of this problem.

Although I am testifying today on behalf of the real estate industry, I cannot emphasize enough that the ultimate victim of the homeowners' insurance crisis is the consumer who is frustrated in his or her attempt to realize the American Dream of homeownership. And when a young family is precluded from owning a home because homeowners' insurance is too difficult to obtain or too costly to afford, we all suffer the consequences.

Last year, NAR testified before this Committee on the difficulties faced by current and prospective homeowners. One year later, the situation has unfortunately not improved. In a number of states throughout the country, including my home state of North Carolina, consumers are burdened by rate increases as well as by reductions in coverage such as higher deductibles.

Since homeowners' insurance is difficult to obtain in North Carolina, many homeowners obtain coverage from our state pool, the North Carolina Insurance Underwriting Association. Although such coverage is expensive and limited, it is often the only alternative.

The inability to obtain affordable homeowners' insurance is a serious threat to the residential real estate market. Not only does it imperil the market for single family detached homes, but the condominium, co-op and rental markets are affected as well. New home purchases, resale transactions and housing affordability are negatively impacted in the following ways:

✓ **Homeowners' insurance is a necessary component in securing a mortgage and buying or selling a home.** If a potential homebuyer is ultimately unable to obtain the required insurance, because the insurance is either unavailable or unaffordable, the sale will not be completed. As a result, creditworthy potential homebuyers are priced out of the market. In a recent NAR survey, respondents reported that an estimated 2,450 transactions fell through because of difficulties in obtaining disaster insurance. Seventy-five percent of respondents cited unaffordability as the reason.

✓ **Homeowners' insurance is tied directly to the cost of owning a home.** If a homeowner is unable to maintain insurance required by a mortgage lender, the mortgage is in default. If disaster insurance coverage is optional, potential buyers may choose not to purchase a home simply because the insurance they consider essential is too expensive. Others may choose to go unprotected.

✓ **Insurance costs impact rent levels.** Insurance costs incurred by landlords are ultimately passed on to tenants. Consequently, increased insurance costs result in higher rents.

**NAR supports H.R. 21 for the following reasons:**

✓ **It protects against mega-catastrophes.** State programs that have been created to address the problem are well-intentioned first steps, and homeowners' insurance is currently available in these states. However, neither state disaster programs nor the private insurance industry have the capacity to cover the risk presented by mega-catastrophes far more damaging than Hurricane Andrew or the Northridge earthquake. The creation of a federal disaster reinsurance program today will help to prevent future interruptions in the availability of homeowners' insurance.

✓ **It promotes fiscal responsibility.** By establishing a program which promotes insurance coverage for those at risk of property losses from a natural disaster, H.R. 21 will minimize future unforeseen disaster assistance expenditures. It is time to begin planning for disasters we all know will occur and to put the responsibility for shouldering the cost of disaster preparedness and response on those who are at risk.

A strong housing market is a linchpin of a healthy economy, generating jobs, wages, tax revenues and a demand for goods and services. In order to maintain a strong economic climate, we must safeguard the vitality of residential real estate.

But more importantly, we must safeguard the cornerstone of the American Dream. NAR supports a federal response to the disaster insurance crisis which helps to make the dream of homeownership a reality for more and more Americans. We urge the Committee to take action this year on this very important issue.

Thank you again for the opportunity to present the views of the NATIONAL ASSOCIATION OF REALTORS®. I am happy to answer any questions.

TESTIMONY OF  
SCOTT A. GILLIAM  
ASSISTANT SECRETARY & DIRECTOR OF GOVERNMENT RELATIONS  
THE CINCINNATI INSURANCE COMPANIES  
BEFORE THE  
HOUSE BANKING AND FINANCIAL SERVICES COMMITTEE  
ON  
THE HOMEOWNERS' INSURANCE AVAILABILITY ACT OF 1999, H.R. 21  
JULY 30, 1999

Introduction

Chairman Leach, Representative LaFalce, Representative Lazio, Representative McCollum, members of the Committee, my name is Scott Gilliam. I am Director of Government Relations for The Cincinnati Insurance Companies, headquartered in Fairfield, Ohio, just north of Cincinnati.

Our group of companies market property and casualty insurance in 29 states through an elite corps of fewer than 1,000 local independent agencies. With nearly one billion policies in force insuring businesses and families, our parent company, Cincinnati Financial, is among the top 20 publicly traded property and casualty insurers based on 1998 revenues of \$2 billion.

I am honored to be with you today to present The Cincinnati Insurance Companies' perspective on H.R. 21. We commend you for your leadership in holding this hearing to address the issues of natural disaster exposure and insurance.

The frequency and severity of natural disasters have created serious issues that the insurance industry and government need to address. In recent years there have been a number of attempts at the federal level to deal with the problems associated with insurance protection for losses arising from hurricanes, earthquakes and other natural disasters.

The catastrophe exposure we face from our own book of business has prompted us to engage in this important debate. Our hurricane exposure in Florida and Alabama alone is nearly \$1.8 billion, representing over 10,000 homes. In the midwest, our estimated exposure from a 6.8 Richter scale earthquake in the New Madrid fault region is in excess of \$13.4 billion, which would damage more than 118,000 homes. These are significant exposures for The Cincinnati Insurance Companies when considered in relation to the current level of assets for our property/casualty group (\$6 billion).



We have been further motivated by several basic concerns which have presented themselves over the years as various legislative proposals, the most recent being H.R. 21, have been presented to deal with the problems associated with insurance protection for losses arising from hurricanes, earthquakes and other natural disasters. These include:

- the need to preserve state regulation of insurance (McCarran-Ferguson Act)
- finding a solution that will enhance private markets and not compete against them
- the need to oppose legislation that is detrimental to any segment of our industry or would unfairly favor one insurer over another

#### The H.R. 21 Proposal

Let me now turn to the legislation at hand, H.R. 21, which would require the Treasury Department to offer federal reinsurance contracts to cover residential losses in the event of a natural disaster. The contracts would be offered for purchase under two programs: (a) for purchase by state-operated insurance pools and reinsurance programs; and (b) for auction to private insurers and reinsurers and to state insurance and reinsurance programs on a regional basis. Payments under the federal reinsurance contracts would be triggered when catastrophe losses from a single event reach a predefined trigger, after which payments would be made to cover losses in excess of the trigger. The maximum amount of claims payable per year under all federal reinsurance contracts issued under the bill could not exceed \$25 billion. Pricing of the federal reinsurance contracts would be established by the Secretary of the Treasury and the Secretary would be permitted to engage in borrowing as necessary to cover pay claims and expenses under the contracts.

We do not disagree that there may be a need for high-level federal involvement in excess of private market capacity to ensure that Americans are provided with appropriate insurance protection for losses arising from hurricanes, earthquakes and other natural disasters. However, we believe that the following principles must be embodied in any legislation which endeavors to provide a federal safety net for catastrophe insurance:

1. The risk of natural catastrophes is best insured in a diversified marketplace which avoids concentration of risk in too few insurers or state programs.
2. The private sector's role, including insurance, reinsurance and capital markets, should be maximized and such financing mechanisms fully exhausted before any government capacity is provided, state or federal.
3. Government's role should be to address insurer solvency in the event of a mega-catastrophe and should not come at the expense of taxpayers.
4. Any federal proposal should include personal and commercial lines of insurance since both forms of coverage are affected by catastrophic events.

Unfortunately, H.R. 21, in its current form, falls short in a number of these areas.

### Low Trigger And New Unfunded Federal Liability

Our primary concern with H.R. 21 is its trigger for payment of losses, a trigger which is far below existing industry capacity. As currently drafted, the trigger for payment of losses is as low as \$2 billion, despite the fact that the industry paid losses from Hurricane Andrew of \$16 to 17 billion, and from the Northridge Earthquake of \$12.1 billion. Why should the government step in at such low levels at a time when the industry continues to gain financial strength? Since 1992, the industry's policyholder surplus has increased from \$162 billion to over \$333 billion today. Fact of the matter is, the industry has handled all catastrophes to date, regardless of their size, and has handled them totally within the private sector.

H.R. 21 will expose taxpayers to new unfunded federal liability. The last thing Washington wants or needs is more unfunded liability. H.R. 21 creates government liabilities at very low levels. With trigger levels as low as \$2 billion, H.R. 21 shifts catastrophe risks from the private markets onto the federal government. And at a time when the property casualty industry has seen its equity surplus grow to over \$333 billion, this form of low-level risk transfer runs counter to conservative principles of less government, less federal spending and a balanced budget.

These concerns were echoed by Treasury Secretary Larry Summers in January of this year when he told a forum for property-casualty insurers in New York that a federal reinsurance program like that proposed under H.R. 21 "should impose no net cost on the taxpayer" and "the federal government cannot be the bill-payer of last resort" for such insurance. However, in the Congressional Budget Office's "Cost Estimate" of H.R. 219, a federal reinsurance bill introduced in the last Congress with features identical to H.R. 21, CBO concluded that "it may not be possible to establish a price for the contracts that would have no present-value cost to the federal government." CBO expressed doubts that federal reinsurance contracts could be priced "so that contract revenues exceed payments" and predicted that passage of the predecessor to H.R. 21 "would likely result in a net increase in direct spending by the government," thereby "expos[ing] taxpayers to a maximum of \$25 billion annually in mandatory obligations to pay purchasers of insurance contracts." We do not believe that CBO's prediction has been taken seriously.

### Government Competition With The Private Market

We are also very concerned that H.R. 21 will supplant the private market and stifle private sector development of new and innovative approaches to the problem of protecting Americans against catastrophic risk. Despite what others may have said today, reinsurance is available and affordable through the private sector for those who properly manage their risk. The federal reinsurance program proposed under H.R. 21 is ignorant of this fact and invites the federal government to compete with and displace private markets for reinsurance. H.R. 21 is a classic "government-knows-best" approach to public policy issues. By offering federal reinsurance to state pools, H.R. 21 encourages states to become insurers and reinsurers of first resort, thereby displacing the private insurers and reinsurers already assuming risks in those markets. The likely result are markets that are dictated by government officials with no room for private market ingenuity.

At a time when the private reinsurance market continues to improve, we are also welcoming the introduction of innovative capital market approaches which are expanding the industry's risk-bearing capabilities for catastrophic exposures. An evolving form of socializing risk through capital market instruments is providing significant new capacity to the insurance industry. In 1997, there were \$1 billion of such transactions, and estimates are that by 2000 they could reach \$25 billion. In fact, it is this type of approach to catastrophic risk protection which Treasury Secretary Summers views as the most promising. As Secretary Summers told the property-casualty forum in New York in January:

"Ultimately, we believe that the most efficient means for underwriting these risks may involve the capital market as an important complement to the traditional reinsurance industry."

But encouraging states to shift property risks out of the private sector will stifle this innovative free market approach, as well as others which may evolve.

### **Proliferation Of State Residual Market Pools And Anti-Competitive Effects**

H.R. 21 will also encourage the development and proliferation of underfunded and overexposed state residual market pools by making federal reinsurance available to these pools at very low trigger levels. Providing subsidized federal reinsurance to state pools will supplant private risk capacity and foster the existence of these pools of last resort which are often underfunded and overexposed (they contain each state's most uninsurable risks and suppress risk-based rates for insurance). If the federal government steps in and offers to indemnify state pools at the low levels contemplated in H.R. 21, there is little incentive for insurance commissioners and state legislators to consider common sense alternatives to underfunded and overexposed pools, e.g., market driven solutions premised upon two of the most essential principles of insurance: spreading of risk and risk-based pricing.

Another concern is the anti-competitive effect H.R. 21 may have on existing markets. Most insurers act responsibly, avoid huge concentrations of risk, and purchase adequate reinsurance or otherwise develop adequate resources to absorb shock losses. Under H.R. 21, these responsible insurers would have to compete against irresponsible carriers who have over concentrated their risk in catastrophe-prone areas and put themselves in a position of having to rely upon state pools or other government mechanisms to absorb shock losses. As one major insurer admitted in a notice to its Florida policyholders after Hurricane Andrew:

"In the past, despite well-intentioned efforts to determine what our policyholders should pay for insurance, we greatly underestimated the costs of covering hurricane damages. Over the years, our policy of providing insurance to everyone who qualified meant we sold our product at too low a cost to too many people. We know now that it is not good business for anyone to insure every third or fourth home in an area where natural disasters strike."

With the low-level federal backstop afforded to state pools under H.R. 21, such overexposed carriers will likely continue to rely on state pools to absorb shock losses and ignore the peril of risk

concentration. Clearly, this gives those companies an immediate and unfair market advantage and rewards irresponsible behavior. Moreover, H.R. 21 would give these carriers further incentive to write insurance in even higher concentrations in high risk areas, further exposing the federal treasury.

### Commercial Risks

H.R. 21 is also flawed in that it does not provide coverage for commercial losses despite the fact that both personal and commercial lines of insurance coverage are affected by catastrophic events. For example, our company's commercial hurricane exposures in Florida and Alabama are nearly as large as our personal lines exposure (personal lines exposure: \$1.7 billion; commercial lines exposure: \$1.5 billion). There is simply no logical reason why commercial risks should be excluded from H.R. 21.

### State Regulation

H.R. 21 will further endanger state regulation of the business of insurance. Since 1945, the insurance industry in the United States has been regulated by the States under authority of the McCarran-Ferguson Act. State regulation of insurance has and continues to work well. H.R. 21 would strike at the heart of McCarran-Ferguson and open the door for the federal government to enter into the business of insurance regulation. For example, if H.R. 21 is passed, it would not be long before the federal government took an active role in the insurance industry. As soon as significant federal dollars are spent to bail out the over-exposed insurers who seek H.R. 21 as a solution to their balance sheet problems, an argument would be made for more federal control over these insurers, and ultimately over all insurers. McCarran-Ferguson has worked well and we need to do all we can to preserve it. The passage of H.R. 21 would imperil McCarran-Ferguson.

### Finding Common Ground

While we have a number of concerns with H.R. 21 as presently drafted, we see little chance for the bill to gain industry-wide support unless the unreasonably low triggers are addressed. The current triggers fall far below the actual claims paid by industry for our Nation's largest insured losses: Hurricane Andrew at \$15.5 billion and the Northridge, California, Earthquake of 1994 at \$12.5 billion. These triggers significantly underestimate private insurance capacity and would likely lead to a major dislocation of private market capacity in favor of federal capacity. To avoid these dilemmas and build a framework under which the industry might find common ground to support a concept like H.R. 21, the Committee should consider a proposal suggested by the Reinsurance Association of America (RAA) during an April, 1998 hearing on H.R. 219, the predecessor to H.R. 21. The RAA suggested that the trigger be structured along the lines of a "conservative rule of thumb" often referenced in the private market:

- Insurers routinely retain catastrophes losses in the normal course of business equal to five percent of industry surplus (\$333 billion x 5%) \$16.6 billion
  - Insurers routinely transfer risk to reinsurers equal to another five percent of surplus (this is an appropriate level for most insurers to transfer; large, highly capitalized insurers would retain this limit). \$16.6 billion
  - For the further development of capital market products allow an additional two percent of industry surplus \$6.7 billion
- \$39.9 billion**

Therefore, an appropriate "trigger" (including residential and commercial coverage) would be \$39.9 billion as of year-end 1998. By using surplus rather than a static number, the trigger adjusts based on the financial experience of the industry. This method of calculation and the accompanying dynamic trigger level would take into account private insurance capacity and would avoid a major dislocation of private market capacity in favor of government intrusion into the marketplace.

#### Conclusion

Regardless of which legislative proposal is ultimately adopted to deal with the problems associated with insurance protection for losses arising from hurricanes, earthquakes and other natural disasters, it is incumbent that we keep these basic principles and concerns at the forefront of the debate:

- The risk of natural catastrophes is best insured in a diversified marketplace which avoids concentration of risk in too few insurers or state programs.
- The private sector's role, including insurance, reinsurance and capital markets, should be maximized and such financing mechanisms fully exhausted before any government capacity is provided, state or federal.
- Government's role should be to address insurer solvency in the event of a mega-catastrophe and should not come at the expense of taxpayers.
- Any federal proposal should include personal and commercial lines of insurance since both forms of coverage are affected by catastrophic events.
- The need to preserve state regulation of insurance (McCarran-Ferguson Act).

We do not disagree that there may be a need for high-level federal involvement in excess of private market capacity to ensure that Americans are provided with appropriate insurance protection for losses arising from hurricanes, earthquakes and other natural disasters. But if this Committee and this Congress is serious about passing legislation to protect policyholders against the perils of natural catastrophes, the legislation ultimately adopted must not encourage government subsidization of catastrophe risk or supplant the private market for insurance and reinsurance.

Unfortunately, H.R. 21, as presently drafted, does not satisfy these minimum criteria.

Thank you for your consideration of this important issue. I would be happy to answer any questions.

**308**

**STATEMENT**

**OF**

**DEAN R. O'NEAL**  
**CHAIRMAN AND CHIEF EXECUTIVE OFFICER**  
**THE CHubb CORPORATION**

**HEARINGS**  
**BEFORE THE HOUSE BANKING COMMITTEE**  
**ON**  
**H.R. 21, THE HOMEOWNERS' INSURANCE AVAILABILITY ACT OF 1959**  
**JULY 20, 1959**

**The Chubb Corporation**  
**15 Mountain View Road**  
**Warren, New Jersey 07061**  
**(609) 968-2000**

I am pleased to submit this statement on behalf of The Chubb Corporation in support of H.R. 21, The Homeowners' Availability Act of 1999.

### **Introduction**

Chubb is a multi-line, worldwide insurer providing property and casualty products and services to customers in all fifty states including, of necessity, many catastrophe-prone areas of the country. H.R. 21 would create a federal reinsurance program to provide high level reinsurance for state disaster insurance programs, affording capacity not provided by the private market. The intent is not to compete with the private sector, but rather to provide high level capacity where none is otherwise available.

We are all too familiar with the economic disruption that hurricanes and earthquakes have caused this decade. Affected communities have faced enormous financial stress. The federal government has spent millions in disaster relief. A federal reinsurance program, such as that under H.R. 21, when accessed by state insurance pools and private carriers, can help bring stability to potentially volatile insurance markets in heavily populated, natural disaster regions. The private insurance sector cannot provide enough capital to insure against mega-event damages, nor can it prevent post-event availability crises in these markets. The situation calls for public-sector help in the form of properly structured residual markets, cat-funds, and federal reinsurance programs. Only through a comprehensive public-private partnership can people be assured that insurers will respond to their losses after an event, and remain viable markets so that commerce can resume with confidence.

### **Role of Residual Market Mechanisms and Their Limitations**

Residual market mechanisms and catastrophe funds, in some states, have proven necessary to stabilize insurance markets following the catastrophic events of the past two decades. Hurricane Andrew and the Northridge earthquake, especially, severely impaired private insurance capacity. In Florida, the legislature created the Florida Residential Property and Casualty Joint Underwriting Association to write homeowners' insurance statewide and the legislature expanded the eligible wind coverage territories of the Florida Windstorm Underwriting Association. The Florida Hurricane Catastrophe Fund served to provide reinsurance to companies unable to get it in the private market. In California, the California Earthquake Authority gave insurers a way to offer a homeowners' insurance market, with necessarily limited earthquake coverage.

Nevertheless, the capacity "crunch" spread after these events to other regions similarly exposed. Insurance became unavailable or unaffordable in coastal communities from Massachusetts to Texas after Andrew, and insurers became nervous about the earthquake exposure in the "New Madrid" area of the Midwest after Northridge. Again, in some of these areas, state mechanisms like those in Florida and California were important safety nets.



Although such mechanisms have proven necessary, they are insufficient to deal entirely with insurance unavailability in areas with serious catastrophe potential. They are just not big enough. It is widely recognized that many years after the most serious disaster events, the residual mechanisms still insure large shares of the market. The availability of "securitized" capital has had little impact on primary insurance availability because it is expensive and untested. Very few new insurance concerns have been attracted to Florida, California, the Gulf-coast and Texas, the Carolinas and the Midwest "new Madrid" region. The "bets" are simply too big and the political environment too uncertain to warrant greater commitments. Accordingly, six years after Andrew the Florida cat-fund plays a key role in many insurers' reinsurance programs.

Certainly, inadequate rates i.e., too little money attracting new capital, are a big part of the problem. Other reasons are inadequate loss mitigation and little consumer risk-sharing. But, these issues are not going to be easily resolved soon, if ever. This is why Chubb believes a federal reinsurance program, could be the complimentary ingredient to finally bring some measure of stability to these markets over extended periods. Federal reinsurance would work like a "backstop" to make sure that the residual markets and cat-funds function as intended, that the industry not be severely impaired by a mega-event, and that well-run small and regional insurers remain viable.

Understandably, some insurers and reinsurers are not happy with residual market mechanisms and cat-funds; nor, are they pleased with the prospect of federal involvement. This is because these companies see the mechanisms as unhelpful and interfering with the free market...and sometimes they do. Residual markets tend to compete with the private market because regulators are pressured to keep the rates unjustifiably low. Catastrophe funds can help financially weaker insurers preserve or gain market share because the reinsurance is usually purchased without a built-in profit margin or extra risk load. However, for the reasons stated below, in the case of H.R. 21, these concerns are misplaced.

#### **Why Stability Should Be the Concern**

Chubb believes that major insurers should be concerned about achieving "market stability" in cat-prone areas, rather than worrying about government interference or the illusory goal of eliminating weak competitors. Stability means healthy competition. In non-catastrophe areas, the individual companies compete vigorously with each other on the relative merits of their products, services and the value of long-term relationships – small and large companies alike. Few complain. The same competitive conditions should prevail in cat-prone areas. Otherwise, only the very biggest, financially dominant companies are able to write business in cat-areas.

To stimulate competitive conditions, some level of state and federal capacity creation is needed. Without it consumers won't have adequate choice and insurers are likely to experience political interference and low profit margins, and growth will be frustrated. If insurers can encourage commerce in partnership with government, there will be plenty of business for all to compete.

### **Key Features of H.R. 21**

Several key features in H.R. 21 are particularly important for achieving this kind of market.

**Triggers** – The “100-year event or \$2 billion, whichever is greater” trigger strikes a good balance between those that want little federal involvement in reinsurance and those that see it as a stabilizing market force. The drafters of the bill wisely allowed for a transition period for newly established funds to build capacity. They also permitted a lower retention level following a major event when losses have depleted a state fund’s liquidity for a subsequent event.

**Pricing** – The “two times expected losses” minimum price for Federal reinsurance is an expensive but reasonable price for the coverage. The market will determine the auction price. In order to help stabilize the market, federal reinsurance must not only be available, but also affordable.

**Loss Mitigation** – The bill requires that 10% of net investment income of the eligible state mechanism go to loss mitigation. This feature highlights the responsibility of states, their businesses, and their citizens to take measures to protect properties most vulnerable to damage. In this way, they minimize the public disaster support necessary following a catastrophe and maximize available insurance capacity for the recovery of all.

### **Summary and Conclusion**

Chubb believes H.R. 21 provides the right mixture of public and private partnership to address long-term insurance availability problems in catastrophe-prone areas of the country. H.R. 21 balances public and private interests. It ensures affordable federal reinsurance capacity when needed without unnecessarily interfering with the private market. It creates a stable, competitive insurance market on which homeowners and businesses can rely. It serves the public interest of helping to quickly restore regions following disasters, thus maximizing the contribution of private insurers and reinsurers.

---

**Statement of Michael R. McGuire  
President of Affinity Bank  
on Behalf of the Western League of Savings Institutions**

**House Banking Committee Hearing on H.R.21  
"The Homeowners' Insurance Availability Act of 1999"  
Friday, July 30, 1999**

Mr. Chairman and members of the House Banking Committee, I am Michael R. McGuire, president and chief executive officer of Affinity Bank, a California chartered Thrift and Loan institution that is applying to become a federal savings institution. We are headquartered in Ventura, California and we currently have three offices located in California. The institution holds some \$225 million in assets. I am pleased to present this statement on behalf of the Western League of Savings Institutions.

The Western League considers the enactment of a natural disaster insurance plan to be one of its highest priorities. This is the third time in two years a witness from the Western League has testified before or presented a statement to this committee to urge the Congress to develop a national disaster policy. We are grateful to Chairman Leach for making natural disaster insurance one of his priorities. We are also deeply appreciative for the leadership of Reps. Lazio and McCollum who have been pushing this plan for more than two years now. I would also be remiss not to mention the leadership of the ranking minority member, Rep. LaFalce, whose support resulted in a majority of the committee's Democrats voting to report out the legislation last year. Similarly, the Administration is playing a positive role as well. It is appropriate that H. R. 21 be non-partisan. Earthquakes and hurricanes are not political events and the development of a national policy on disasters must not be politicized.

Critics of H. R. 21 contend that we should not be adding still another federal program to the statute books -- that the private sector, possibly with new tax incentives, or the securities markets can handle the problem. The program is also open to criticism that it benefits disaster prone states, like those on the Atlantic coast, the gulf states and the west coast at the possible expense of citizens of other states. We have a different view. Given the generosity of our citizens, our government always responds to the needs of disaster victims, wherever they are.

When terrible things happen we do not ask what states are providing and what states are receiving aid. But as a matter of national policy, we should encourage those who live in areas susceptible to natural disasters to make financial preparations. The problem right now is that adequate protection is neither available nor affordable. National policy should be to encourage the citizens of California, Florida, the Carolinas and the gulf coast states to provide some of their own protection. Far from being a subsidy that comes from the pockets of citizens in non disaster prone states, H. R. 21 will make disaster victims less dependent on the generosity of Americans from other states. It is good public policy.

The California Earthquake Authority (CEA) was created following the Northridge earthquake in 1994 to help provide insurance which the private sector understandably stopped offering in light of its losses from that disaster. In fact, the Northridge quake followed two other serious events, the Whittier earthquake in 1987 and the Loma Prieta earthquake in 1989 so it is understandable that property insurers would pull in their reins. The California Department of Insurance reported that 95% of the insurance companies in the state would not underwrite any new coverage after Northridge. With CEA, insurance became available again, but premiums doubled and deductibles increased significantly. This remains the situation in California today. We are largely uninsured. Less than one in five eligible Californians even carries earthquake insurance today because it is so expensive and because the deductibles are so high that in many cases they exceed the equity people have in their homes. According to the CEA, of 7.9 million eligible properties in California, only 1.3 million are insured. In other words, 83% of eligible homeowners and apartment dwellers in the state do not carry earthquake insurance. The reason is that the cost of reinsurance is so high that premiums are either beyond the means of most people or people do not consider the insurance to be worth the cost. We do not believe we can do significantly better without a national backup.

We do not pose as experts on the exact level at which the federal government should be involved – whether the bar should be set at a 100-year event or a 250-year event. Given the amount of competition the thrift industry is exposed to from government programs, we are sensitive to industry arguments that they do not want to be crowded out by the government itself. Our own business is dominated today by government programs and by the GSEs. We do, however, reject arguments that the plan contemplated by H. R. 21 is a bailout of the insurance

industry. Natural disasters, particularly earthquakes, have the potential to cause devastation over very large areas and there is no way the insurance industry can price this risk at levels where adequate coverage can be made available at affordable rates. It simply is not feasible to think the private sector can handle losses of magnitude that would occur if a massive earthquake hit directly in a highly populated area. Given the level at which the bar is likely to be set, we may not make significant strides in affordability, but at least natural disaster insurance will be more readily available.

We are aware that there is some support for another plan -- one which does not contemplate a role for the Federal government in providing insurance -- only a federal cost by making the accumulation of reserves for disasters tax free. As Chairman Leach is well aware and as he has pointed out in a different context on several recent occasions, our industry used to have a tax incentive to make mortgage loans. The thrift industry was permitted to accumulate reserves on a tax deferred basis. At one point these annual deductions were at a level of 60% of mortgage interest income received. As government mortgage programs proliferated there was less and less reason to provide subsidies to our industry to make mortgage loans, and the amount of the annual deduction was lowered over a number of tax bills to just 8% of mortgage interest received. Meanwhile, the reserve itself became a severe constraint as our industry had to diversify. A tax incentive is not generally a very efficient mechanism with which to dispense a subsidy, and it is extremely difficult to end if national priorities change. In this case, we believe the subsidy, if in fact there ever is a need for one (a triggering event occurs before an adequate buildup of private reserves), is probably most efficiently provided through a risk acceptance mechanism rather than a tax incentive. Enforcement will be far easier as will required risk mitigation.

Given other responsibilities of this committee, there ought to be concern about the level of risk to which financial institutions, the housing GSEs, FHA, VA and the FDIC are currently exposed. For financial institutions, the potential of loss from natural disasters probably exceeds the potential of loss from economic calamities. Few financial institutions can or do require borrowers to carry disaster insurance though homeowners' insurance is virtually mandatory in every state. The lending fraternity could far more prudently insure itself for fire and theft than it can for natural disasters. This potential for loss is, unfortunately, concentrated in our most populated areas -- eastern seaboard cities and California. Our hope is that Congress will enact a

national disaster policy, anchored by federal reinsurance of catastrophic losses before the next event occurs — and it will — we just do not know when or where.

Last year, many technical and political problems were worked out by this committee. In the end, the legislation passed this committee by a fairly decisive margin. We urge you to approve it again this year, by an even wider margin. The principles we espouse, which were incorporated into H. R. 219 last year, and which should be part of this year's bill as well are:

- \* The legislation should reflect public policy rooted in the principle that those who live in areas that are at risk should be encouraged, and perhaps some day, required to provide protection for themselves;
- \* A federal solution is needed. There are some things that only government can do, and this is one of them;
- \* Insurance must be made readily available with the understanding that there is a direct relationship between the level of government involvement and the affordability of the insurance. The priority though must be on availability;
- \* Mitigation must be made a part of the program; and
- \* Multi-family residences should be eligible along with single-family dwellings.

We hope the Congress will move quickly on this legislation.







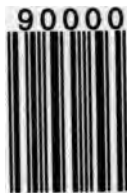




ISBN 0-16-060232-7



9 780160 602320



90000

STANFORD UNIVERSITY LIBRARIES  
106-1 Hearing: H.R. 21-The Homeowners'  
Y 4.B 22/1:106-34



3 6105 05012380 6







CECIL H. GREEN LIBRARY  
STANFORD UNIVERSITY LIBRARIES  
STANFORD, CALIFORNIA 94305-6004  
(650) 723-1493  
grncirc@sulmail.stanford.edu  
All books are subject to recall.

DATE DUE

